

RESEARCH AND EXPERIMENTAL SOURCE ALLOCATION RULES

HEARINGS BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES NINETY-EIGHTH CONGRESS FIRST SESSION

OCTOBER 26; NOVEMBER 3, 1983

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RESEARCH AND EXPERIMENTAL SOURCE ALLOCATION RULES

WEDNESDAY, OCTOBER 26, 1983

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met at 9:48 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

[Press release of Monday, Oct. 3, 1983]

HON. CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE SCHEDULING OF THE HEARING ON RESEARCH AND EXPERIMENTAL SOURCE ALLOCATION RULES

Congressman Charles B. Rangel (D., N.Y.), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means announced today that a hearing has been scheduled for Wednesday, October 26, 1983, to consider the temporary rule which allocates and apportions all research and experimental expenditures for research activities conducted in the United States to sources within the United States. The hearing will begin at 9:30 a.m. in the Committee on Ways and Means Main Hearing Room, 1100 Longworth House Office Building.¹

Section 223 of the Economic Recovery Tax Act of 1981 (ERTA) provides a two-year rule that allocates all research and experimental expenditures which are paid or incurred for research activities conducted in the United States to U.S. sources, for all purposes under the Internal Revenue Code (I.R.C.). This rule is effective for the taxpayer's first two taxable years beginning after the date of enactment, August 13, 1981, and has the effect of placing a temporary moratorium on the relevant portions of Treasury Regulation 1.861-8. In addition, ERTA directs the Department of the Treasury (Treasury) to conduct a study of the impact that the research expenditure allocation provisions of Treasury Regulation 1.861-8 have on both research activities conducted in the U.S. and on the availability of the foreign tax credit. (Treasury released their study in June 1983 and recommended a two-year extension of the present moratorium.)

The Subcommittee hearing will (1) focus on the findings and recommendations contained in Treasury's June 1983 Report, "The Impact of the Section 861-8 Regulation on U.S. Research and Development", and other related analyses, (2) consider the policy implications of not requiring expenses to be allocated between U.S. and foreign source income (including the incentive under present law to make tax free transfers of technology for use in manufacturing operations abroad), and (3) examine the research activities and location response of taxpayers who have received tax benefits under the temporary ERTA allocation rule. For additional information see the Subcommittee's previous hearing announcement: Subcommittee on Oversight, Press Release No. 8, Tuesday, September 20, 1983.

¹ A subsequent press release dated Oct. 18, 1983, announced an additional day of hearings to be held on Thursday, Nov. 3, 1983, beginning at 2 p.m.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler ((202) 225-3627) no later than noon Friday, October 14, 1983, to be followed by a formal written request to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement will be included in the printed record of the hearing. This process will afford more time for Members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Subcommittee are required to submit 5 copies of their prepared statement to the Subcommittee office, Room 1101 Longworth House Office Building, by close of business, Friday, October 21, 1983, and 100 copies to the full Committee office, Room 1102, 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

Each statement to be presented to the Subcommittee or any written statement submitted for the printed record must contain the following information:

1. The name, full address, and capacity in which the witness will appear as well as a telephone number where he or his designated representative may be reached;
2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of comments and recommendations.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Persons submitting a written statement for inclusion in the printed record of the hearing are required to submit at least six (6) copies of their statement by the close of business, Friday, November 4, 1983, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, additional copies may be submitted for this purpose if provided to the full Committee office before the hearing begins.

Chairman RANGEL. The Subcommittee on Oversight of the Committee on Ways and Means will please come to order.

This morning the Subcommittee on Oversight will receive testimony concerning rules that affect the allocation and apportionment of expenses for research and development activities conducted in the United States between United States and foreign income sources. The allocation and apportionment rules provided for under Internal Revenue code, section 861, and related code sections are relevant to a taxpayer's calculation of taxable income for purposes of the foreign tax credit, disc computations, and other provisions of the code.

While the code generally requires the allocation of expenses, losses and other deductions between United States and foreign source income, the allocation rules as applied to R&D expenses are complex and have been particularly controversial.

The Department of the Treasury issued a regulation concerning R&D allocation rules, as required by statute, in proposed form in 1973 and in final form in 1977. This regulation is the so-called section 861 regulation or Treasury regulation 1.861-8. As part of the Economic Recovery Tax Act of 1981, ERTA, Congress included a

temporary provision which has the effect of suspending the relevant portions of the Treasury regulation, 1.861-8.

Under the ERTA provision, all R&D expenses are allocable to U.S. source income for a taxpayer's 2 taxable years following enactment of ERTA. Inasmuch as ERTA was enacted on August 13, 1981, the temporary provision will be expiring, or has already expired, for many taxpayers.

The subcommittee's hearing will focus on three major issues:

One, the findings and recommendations contained in the Department of Treasury's June 1983 report, entitled "The impact of the section 861-8 regulation on U.S. research and development" and other related analysis;

Two, the policy implications of not requiring expenses to be allocated between U.S. and foreign source income, including the incentive under present law to make tax free transfers of technology for use in manufacturing operations abroad; and three, the research activities and location response of taxpayers who are affected by changes in source allocation rules.

As I mentioned previously, the temporary ERTA allocation rule expires very soon. The purpose of the hearing today is to examine, in a comprehensive manner, the issues surrounding code sections 861-3 and the implementing regulation. The hearing will provide the Committee on Ways and Means with a complete record of information on the subject, allow for the presentation of contrasting views, and will assist the committee in weighing the appropriateness of present law rules as implemented by the Treasury regulation, the temporary allocation rule as provided for in ERTA, or other legislative or administrative options.

Before the first witness, I want to announce a change in the subcommittee's hearing schedule. In addition to our hearing today which will end at 1:30 p.m., the subcommittee will also receive testimony on this matter on Thursday afternoon, November 3, from 2 p.m. to 4:30 p.m. The hearing on November 3 will also be held in the main committee hearing room, 1100 Longworth House Office Building.

We have a distinguished group of witnesses scheduled to appear today and on November 3. I welcome each of you and look forward to receiving your testimony.

If there are opening statements to be made by my colleagues, I would recognize them for that purpose.

If not, our first witness will be Congressman Jim Shannon from the sovereign State of Massachusetts. We welcome you and your testimony this morning.

**STATEMENT OF HON. JAMES M. SHANNON, A REPRESENTATIVE
IN CONGRESS FROM THE STATE OF MASSACHUSETTS**

Mr. SHANNON. Thank you, Mr. Chairman. And thank you, members of the subcommittee.

I appreciate the opportunity to appear before you today. I want you to know that I believe it is essential that Congress act on the section 861 problem before the end of this session. I also think that the best action we could take would be to do away altogether with Treasury regulation 1.861-8.

In 1981 the Ways and Means Committee, and Congress as a whole, made an important policy decision. By enacting a tax credit for companies that increase their R&D spending, we recognized the fact the R&D is going to be one of the most important elements in the ability of the United States to remain competitive with other industrialized nations. In a high technology era where constant innovation and product improvement are the key to success, we simply have to have a solid domestic R&D base. And the alarming fact was, we were beginning to lose that base.

Civilian R&D had been stagnating since 1968, staying at about 1.5 percent of GNP, while in Japan it had grown to 1.9 percent, and in West Germany 2.3 percent. There is evidence that the credit has helped provide an incentive to turn this around.

Companies have substantially increased their R&D spending in each of the past few years, despite a recession which led to cut-backs in capital spending.

The fact that we also imposed a moratorium on the implementation of Treasury regulation 1.861-1 that same year was a further recognition of the importance of building up our domestic R&D base. As I am sure succeeding witnesses will tell you, this regulation, which requires a company with foreign operations to allocate some of its domestic R&D expenditures to foreign source income, will be a disincentive to conducting R&D here in the United States. If our aim is to improve our domestic R&D capacity, such a regulation simply does not make sense.

This regulation discourages domestic R&D spending because even though the IRS may allocate domestic expenditures to foreign source income, those countries where the income is received may not. Allocating those expenses to foreign source income has the effect of reducing that income for U.S. tax purposes, and thus lowering the limit on the amount of foreign tax credit a company can take.

This may place the company in an "excess credit" position, restricting its ability to offset foreign against domestic tax liability. At the same time, the foreign country may tax the company on that income with no deduction for the expenses allocated to it by the United States. Thus, a company operating abroad may find that doing its R&D in the United States leads to increased tax liability and double taxation of some foreign earnings.

Few countries require this sort of allocation of R&D expenditures of domestic R&D expenditures. Furthermore, many of the other countries with whom we compete offer a variety of incentives to encourage companies to conduct R&D within their borders. Thus, this regulation places U.S. companies doing their R&D at home at a competitive disadvantage with companies operating in these countries and places the United States at a disadvantage in its attempts to increase the amount of R&D conducted in this country. At a time when we are fighting to maintain our position in the world economy, I see no sense in creating an incentive to send R&D jobs abroad.

I am aware that some of the analysts who will come before you today are going to say that as a matter of pure, clean tax policy, allocation should occur. In an ideal tax system, income is matched to expenses, and if some of a company's income is coming from

abroad, then some of its expenses should be allocated to that income. They will tell you that the current Treasury formula may not be the best one, but that some kind of allocation formula should be used.

Well, they are right on one point: the Treasury formula does not provide a good allocation. The allocation of R&D expenses on the basis of SIC product groups results in distortions, because much of the income within the group may be completely unrelated to the expenses involved. So, at the very least this formula should be changed.

However, I seriously doubt whether it is ever going to be possible to devise a system that will really produce an accurate matching. And I fear that whatever system you come up with will be just as complicated and just as burdensome for companies to deal with as the one in the current regulations.

But once you get beyond all the arguments as to which formula is best, there is one essential point that I think is inescapable: We have never let pure tax policy be our only consideration in matters like this.

The code is full of provisions that make no sense as a matter of pure tax policy but which Congress felt were justified by social or economic considerations that were just as important. I cannot emphasize strongly enough my belief that this is one of those cases: the importance of maintaining and improving our domestic R&D capacity, and the jobs associated with it, far outweighs any other consideration.

You will be told that only a couple of dozen big multinationals have sufficient foreign income and are close enough to exceeding their foreign tax credit limit to be affected. Even assuming this is true, how do we know that more companies won't be affected in the future? More to the point, I think that any provision that encourages the movement of jobs, from whatever source and in whatever numbers, out of the United States and into a foreign country is bad policy and should not be implemented.

It is true, of course, that this movement of R&D outside the country will occur only to the extent that the allocation rules are a determining factor in a company's location of its R&D operations. But I feel quite confident in stating that the rules will, indeed, be a determining factor. My confidence is based on conversations with corporate representatives who have said their decisions on where to base their R&D operations will depend on the resolution of the 861 question. It is also based on studies by respected analysts that say much the same thing.

The National Research and Development Survey issued last January by Arthur Andersen & Co. made this point very clearly. The survey of 85 corporations found that R&D investments by U.S. companies in foreign markets was increasing faster than in U.S. markets. Those surveyed said that Government incentives or disincentives played a significant role in their R&D decisions, and a number of them specifically mentioned regulation 1.861-1 as a detriment to domestic R&D operations.

Forty-four percent of the respondents stated that if the moratorium on this regulation was lifted they would be in an excess foreign tax credit situation, and most of those surveyed believed that lift-

ing the moratorium would encourage an expansion of foreign R&D investments in the future.

The same conclusions were reached by a Tax Notes study published last June. The author of that study constructed an economic model to examine the probable corporate response to a reinstitution of the 1.861-1 rules. He found that implementation of these rules would exert pressure on corporations to reduce domestic R&D and would create problems for firms planning to enter export markets.

His conclusion was that:

To enhance the American international trade sector and provide comparability between the tax treatment of foreign and domestic income, the moratorium on section 1.861-1 of the regulations should be continued.

Finally, the Treasury Department undertook a study, which was also issued in June. That study found that if the section 861 regulations had been in effect in 1982, privately financed R&D domestic R&D spending would have been reduced by anywhere from \$40 million to \$260 million. Treasury concluded that since a reduction in R&D spending could adversely affect the competitive position of the United States, the 2-year moratorium should be extended.

But once you accept the premise that these regulations do, indeed, create a disincentive to domestic R&D, what is the sense of extending the moratorium? All that does is force the affected companies to live with uncertainty for another 2, 3, or however many years. Many high technology firms do their R&D planning on a longer cycle than that, typically 3-to-5 years. They want to plan their R&D operations now, and an extended moratorium just isn't going to be much help to them in doing that.

For that reason, I have joined my colleague Cec Heftel and a majority of the Ways and Means Committee in sponsoring H.R. 1887, which would settle the question once and for all by doing away with the 1.861-1 regulations and requiring that expenditures for R&D conducted within the United States be allocated to U.S. source income. I think that this bill represents the best solution to the section 861 problem, and I hope that we will see action on it soon. Our ability to compete in world markets and create jobs at home is too important to either sacrifice on the altar of tax policy or leave to the uncertainty of another moratorium.

Thank you, Mr. Chairman.

Chairman RANGEL. Thank you, Mr. Shannon.

I assume that what it boils down to is that we have a couple of dozen multinational corporations that believe that their tax liability as it relates to research and development would be increased if we don't make the changes that you are suggesting. It would be for these companies that have excess foreign credits that you fear this increased liability might cause them to shift their research and development overseas in an effort to reduce their tax liability; is that correct?

Mr. SHANNON. Well, I am afraid they will shift some of their research and development efforts overseas. Other countries offer great incentives for investment and I am afraid that there will be an incentive in future planning of R&D activities to move some of that overseas.

Chairman RANGEL. But it would be really the profit motivation. I guess they have shared with you and not with me really, that we would be losing jobs and a lot of research information if we don't give them some type of tax relief?

Mr. SHANNON. Well, ultimately that is the fear. I think that what we should be trying to do is, in as many ways as is possible, encourage more expenditures in R&D here at home.

Chairman RANGEL. I don't think anyone disagrees with that.

Mr. SHANNON. I think to a certain degree these 861 regulations encourage these companies—many of whom have large foreign markets—to take their R&D and bring it closer to their markets for tax reasons. I think that that is a loss to our economy and to our Nation and one we should try to avoid.

Chairman RANGEL. I don't think there is any part of our Tax Code that is left pure so I don't argue that we should just maintain good tax law because it is good tax law. However, it does seem to me that generally your position has been that where you can provide incentive, you provide it, and do what you want to do, and make it abundantly clear to people that you are doing this to reach a certain goal.

It appears to me that we really don't know what is happening but we stand a chance that some of the multinationals will shift their R&D overseas. Otherwise, we are just hoping they don't do this. It is only those that have excess foreign credits involved. So it seems we are getting all of this law just for a few corporations to reduce their tax liability hoping that they will stay with us.

Mr. SHANNON. Well, I think what we are saying is first of all there is no question that some of our largest corporations do a whole lot of the R&D work that is done in the American economy and to the degree they are doing that we should encourage them to do more.

The other point I would like to make, Mr. Chairman, is this: In 1981 we did some terrible things in that tax law and we did some good things. We did things that clearly didn't work and we did things that clearly have worked. Since 1981 capital investment has gone down in the country despite many of the provisions adopted in 1981 were geared toward encouraging capital investment.

Capital investment has gone down, investment in R&D has gone up. Why? Because we were putting provisions in, part of the reason is we put the provisions in to encourage R&D here at home. We put in a tax credit. We did the 861 provisions to keep it from going abroad. It is one aspect of our tax policy in 1981 that I think has worked despite what the critics said in 1981 and despite what some have said since 1981.

But even with those incentives put in in 1981, I think there is a consensus in the Congress and the country that the United States still faces a crisis in encouraging R&D in scientific innovation.

We have to establish some policies to encourage more of that over the period of the next couple of years. Some of that I hope will be increased Government support for agencies like the National Science Foundation. Some of it will be a real full-scale effort to train and educate technical people. Some will be more strengthening of the areas of tax incentives to encourage R&D.

I think this would be the worst possible moment to put a disincentive in the tax laws that doesn't exist. I fear that failure to act on the 861 regulations will begin to move us in the wrong direction.

Chairman RANGEL. Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Shannon, I don't think I have a lot of questions. I followed your testimony carefully and you make some strong arguments. You testified that the R&D allocation requirements create a disincentive for domestic R&D or create an incentive for R&D to move abroad.

The Treasury apparently recognizes there is some validity to that argument. And they recommend a 2-year extension of the moratorium. You recommend a permanent rule and I am inclined to believe that is the best route, but tell me, why is the 2-year extension less preferable to the permanent approach?

Mr. SHANNON. We would be willing to split the difference with Treasury between 2 years and eternity, Mr. Pickle—75 years, 80 years? I would be willing to compromise on that point.

But I think that the problem is this: traditionally research and development expenditures are planned a long time in advance. We have people in our greatest high technology corporations in the country, many of which are located in your area, many located in mine, who are thinking today and working today on projects that really won't be ready to go to market for several years.

We know that. Thank God they are doing that and looking ahead that far.

That is the only way that we are going to be able to keep our competitive edge, Mr. Pickle.

They know in order to be competitive 10 years or 20 years from now they have to make R&D expenditures today that might not see any payback for that period of time.

With this uncertainty as to the tax incentives that exist for research and development they have, I think, some of that incentive inhibited and diluted. We want to remove that cloud. We want to allow them to do long-term planning for R&D and have some sense of certainty as to how they will have income treated for tax purposes and that is the reason I would say we would have to go way beyond 2 or 3 years and perhaps we should just make this change in the law permanent and look at it again in a few years and see whether or not we still feel the same way.

I think everybody knows we have the option of doing that. I expect we will do that.

Mr. PICKLE. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. I have no particular questions. I agree with what Mr. Shannon has said, I think it is a very important subject and it is something that I think the full committee should have before it as soon as possible.

I know it affects all areas of the country and we are all concerned with it. Thank you, Jim, for your excellent contribution.

Chairman RANGEL. Mr. Anthony.

Mr. ANTHONY. I have no questions.

Chairman RANGEL. Mr. Dorgan will assume the chair now for a while while I testify in front of another committee.

Mr. DORGAN [presiding]. Mr. Shannon, do you have anything to add?

Mr. SHANNON. No, sir.

Mr. DORGAN. Thank you very much for your testimony.

The next testimony will be presented by Charles Kingson of Willkie, Farr & Gallagher in New York City.

STATEMENT OF CHARLES I. KINGSON, WILLKIE, FARR & GALLAGHER, NEW YORK, N.Y.

Mr. KINGSON. Thank you, Mr. Chairman.

Congressmen and members of the subcommittee, thank you for inviting me. I am Charles Kingson, and I practice tax law in New York.

My testimony is not intended to present any particular point of view and it is not intended to discuss jobs or economic effects. I volunteered and intend to explain what the moratorium actually does. I will do so in five steps.

The first is what the section 861 regulations do. The second is why they are important. The third is what the moratorium does. The fourth is what happened before the moratorium. The fifth is where we are now.

Now I am going to try to be as brief and as nontechnical as possible but I think that it is impossible to understand what is happening without looking at arithmetical examples. It seems to me that the more abstract presentations are—and I have read testimony on the 861 regulations—the more they stray from what is really happening in a dollars and cents situation, particularly with reference to relocating abroad. To say that a foreign country gives a deduction and the United States does not is really only to begin that analysis, as I will try to show with examples.

So if you bear with me, I will refer to various examples at different pages of my written statement.

Basically, the United States divides total income into foreign income and U.S. income. Foreign taxable income is determined by taking foreign gross income and deducting the deductions. For example, if I am a law firm with an office in Paris that earns \$100 in fees and an office in New York that earns \$100 in fees, I have foreign source gross income of \$100 and U.S. source gross income of \$100. But clearly my foreign and U.S. source taxable income is not the same because my Paris expenses for rent and electricity, et cetera, are probably different from my New York expenses.

What the 861 regulations do is to allocate a more difficult type of expense, research expense, in order to determine foreign taxable income. Now, foreign taxable income is important because in theory the U.S. foreign tax credit is limited to the U.S. tax on foreign taxable income.

If you look at the example on page 1 you will see U.S. income of \$100 and foreign income of \$100, on which the company has paid foreign taxes of \$60. The foreign tax credit limitation limits foreign tax credit to \$50, the U.S. tax on the foreign income. If you allowed

a credit of more than \$50, the company would pay less U.S. tax than if it had had no foreign operations.

If the company in the example had no foreign operations, it would pay a U.S. tax of \$50. The purpose of the foreign tax credit limitation, therefore, is to be sure that the U.S. company pays no less tax than it would if it had no foreign operations whatever.

Now, a simpler way of viewing this limitation as the U.S. tax on foreign income is to assume a 50-percent U.S. tax rate and say that the limitation is 50 percent of foreign source income. When the foreign tax paid reaches 50 percent of foreign source income then the useful concept—and I think it should be used—is that the foreign income is exempt from U.S. tax. It is not exempt as a theoretical matter, but since there is no U.S. tax payable on it, it is just the same as being exempt.

Once it is exempt, there are two categories of income: foreign income—which is exempt income—and U.S. income, which is taxable income.

If you look at the example on page 3 you will see a case where the foreign income is \$100, and \$50 of foreign tax is paid. The U.S. income is \$100, and \$50 of U.S. tax.

At this point there are, say, \$20 of research expense to be allocated. The question becomes, should it be allocated to U.S. income, which is taxable, or to foreign income, which is exempt? If it is allocated to U.S. income, you will see the U.S. income is \$80 and the \$20 deduction reduces U.S. taxes to \$40. If the deduction is allocated to foreign income, it reduces foreign income to \$80; but since that income is exempt from U.S. tax, the company really gets no tax benefit from it. So the question is really should income be allocated to foreign exempt income or to U.S. income.

Until the foreign income is exempt from U.S. tax, companies do not care about the 861 allocation. The example, on page 4, shows that if you have foreign income of \$120 and foreign tax of \$50, you will pay U.S. tax of \$10. This is because the U.S. tax on \$120 of income is \$60 less a \$50 foreign tax credit.

Even if you allocate \$20 of deductions to foreign income, you will have foreign income of \$100 and foreign tax of \$50, so you will save \$10 of U.S. tax. The only people who care about this moratorium, therefore, are people whose foreign income is already exempt from U.S. tax.

Those people want to increase their foreign taxable income as much as possible in order to exempt more income from U.S. tax. If they increase it artificially, they are exempting from tax not foreign income but U.S. income.

The entire moratorium is an effort to take a figure that belongs in column 2 and put it in the column 1. For example, go back to the example in two columns at the top of page 4. If, indeed, the proper economic allocation was that the \$20 research expense should go to foreign income, the moratorium would instead put the two columns in the way they are at the bottom of page 3. It would take the \$20 of foreign deductions properly attributable to foreign income and put them into the U.S. income column. So in effect what the moratorium does is to exempt \$20 of U.S. income from U.S. tax.

The equivalent of this can be seen less abstractly where income is literally exempted from U.S. tax. In the middle of page 6 I give an example of an American who works abroad. Since he works abroad, his foreign earnings are exempt from tax. He earns \$100 of foreign fees and has \$20 of business expenses, so he has net \$80 of foreign earned income which is exempt from U.S. tax.

Assume further that he has \$20 of General Motors dividends which, if he didn't work abroad, the United States would tax. If instead of saying he has \$80 of exempt income—the \$100 he earned minus \$20 business expense—and \$20 of taxable income—the General Motors dividends—you take the \$20 of business expense attributable to fees earned abroad and use them to eliminate the U.S. tax on \$20 of dividends, you have—because of business expenses incurred abroad—exempted U.S. dividends from tax.

That is exactly what this moratorium does. Now this is not the first time that the Internal Revenue laws have exempted U.S. income from tax through 861 allocations. In 1973, regulations were proposed which said that you allocate your research expenses in proportion to your sales. Thus, if you had \$100 of research expenses and half of your sales were going to be abroad, you would have allocated \$50 of research expenses to foreign sales and \$50 to U.S. sales.

At that time companies made the same arguments I assume they will make today. They said that they would move abroad, and they also made what I think was an extremely persuasive argument. Basically, they said it is unfair to adopt these regulations if they put us in what I will call a negative research position, that is, a position in which the deductions allocated under the 861 regulations exceed the amount of royalties that our foreign subsidiaries are allowed to pay us.

The effect of a negative research position can be seen in the example beginning at the bottom of page 7. Assume that the foreign subsidiary, F, and its parent, P, each have \$150 of income. F is allowed to pay P a \$30 royalty, so that for foreign purposes its income is \$120 and its tax is \$60.

The next page shows an allocation of \$50 research expense by the United States to foreign income. This means that for the U.S. purposes the foreign taxable income is only \$100. The foreign country, therefore, considers as F's taxable base—that is, the amount on which it is going to impose corporate tax—to be \$20 higher than the United States does. This occurs because the United States allocates \$50 of research expense to F's income, whereas the foreign country allows F to deduct only \$30 for that research in the form of paying P a royalty.

Therefore, even if the tax rates are the same, more tax will be paid in the foreign country than P can credit; and that was felt to be an incorrect result, unfair to the companies. It is particularly unfair since several countries—Germany is quite well known in this area—discriminate and do not allow royalties paid to U.S. parents to be what arguably is the economic worth of the technology transferred.

The 861 regulations, as adopted in January 1977, responded sympathetically to this argument by not requiring allocation of research expenses on the basis of sales. Instead, they permitted allo-

cation to foreign source income of as little as about one-third of the percentage of sales abroad. If the percentage of sales abroad was 50 percent, this permitted a company to as little as \$17.50 of each \$100 research expenses, or 17.5 percent—which is about one-third of 50 percent—to foreign source income.

That was intended in large part to avoid the negative research position. It is important to understand that if a company is not in a negative research position—in other words, if the amount of deductible royalties which foreign subsidiaries pay to their U.S. parent equals the amount of research expense that the section 861 regulations allocate to foreign source income, then unless there are foreign withholding tax on the royalties, the company has no tax incentive for relocating the facilities abroad no matter how much excess credit position it is in.

I try to show that by the example on pages 10 and 11. Assume that a parent and a subsidiary each have \$100 of taxable income, the parent in the United States paying \$50 of U.S. tax, the subsidiary with \$100 in the foreign country paying \$50 of foreign tax. Assume from that there is a choice between doing the research in America or doing the research abroad. If P does the research in America, it will wipe out the \$50 U.S. tax and save \$50 if there is no allocation to foreign income under the moratorium.

If F does the research in a foreign country, it will save \$50 of foreign tax in the foreign country by wiping out the foreign tax. Now, however, on page 11, the example shows that if F is allowed to pay P an amount equal to what the section 861 regulations allocate to F's income, that is \$17.50, that net result is still total tax of \$50 saved although it is not all saved in one country.

Basically then unless there are substantial withholding taxes—which would increase the tax on P—a company does not have a tax incentive to go abroad.

Even if there are substantial withholding taxes, it only pays the company to go abroad if the other country will give a better section 861 allocation than the United States will. A 1980 convention of the International Fiscal Association, presented reports on the 861 policies of various countries, and the summary by a distinguished U.S. tax lawyer in the published version, in effect, said they are uncertain. The 861 issue has not surfaced.

Frankly, I don't think that most foreign countries have focused on what an 861 allocation should be. We are way ahead in spotting the issue and making rules than are foreign countries. A company which is not in a negative research position has a tax incentive to relocate its research abroad only if there are substantial withholding taxes, and in that case it is gambling on the foreign country's 861 position, which may or may not be known—unless you can get some agreement.

There are two other things you should consider. When a company talks about going abroad to do research, it just doesn't start from scratch. It has an organization. It has know-how and plans and work in progress. If you move that abroad to a foreign subsidiary, the Internal Revenue Service may be able to impose a substantial tax as if you had sold the whole value of that research facility for its fair market value. Moreover, the fruits of research by for-

eign subsidiaries—unlike research by the U.S. parent—will not as a practical matter enjoy the tax benefits accorded by Puerto Rico.

That is a possible deterrent to going abroad. The other thing to consider is that people will say I can get tax savings because the foreign country allows a deduction. But, you don't get a deduction without having income. The foreign subsidiaries income will soon be increased because by doing the research, it will soon have a parent or know-how that it will license to the U.S. parent.

The subsidiary's income will thus be increased by the fact that instead of paying a royalty to the U.S. parent, it will be receiving a royalty from the U.S. parent. Pretty soon the combination of royalties not paid to and royalty received from other affiliates may well equal the research expenses in the foreign country. In that case you are not talking about saving tax in the country of research; you are talking about saving tax in the United States, because the United States will not discriminate and will therefore allow a bigger royalty to be paid to the country of research than a foreign country would if the United States were the country of research.

To a large extent, then, research might be relocated abroad in, say, Germany, not for the deductions but because the deductions in Germany ultimately come from third countries like the United States in the form of royalties to the country that does the research.

Accordingly, say that a company will move abroad because a foreign country allows the deduction without talking about the 861 policies of that foreign country, or to say that the deduction will save tax in that country without speaking of the corresponding royalties that must be charged is to speak in terms that obscure what is happening here. A company might move abroad in order finally to pay royalties from the United States and to save U.S. tax. When the U.S. parent pays royalties, the royalties are just for the U.S. rights to technology, and there is no allocation of the deduction to foreign income.

Now, to conclude I would like to summarize where we are today.

The companies have a rather sympathetic case, but in many instances, not for the reasons they may state. The companies excess foreign tax credit predicament occurs for a number of reasons. First, the United States has an overall foreign tax credit which allows the very high tax rates on developing countries to be averaged with the somewhat lower rates of developed countries. Next, we have congressional policies that prevent obtaining treaties which lower developing country tax rates.

The most relevant reason, however, may be that many industrialized countries discriminate against U.S.-owned companies. They discriminate not only in the tax base, but they have a higher tax rate on U.S.-owned companies than they have on their own companies.

To that degree, if the U.S. Treasury cannot protect its companies from overtaxation abroad, then the companies have a good case to go to the Treasury or the Congress and say, well, then protect us from that at home.

However, you understand that the consequences of that is that because other countries are discriminatorily overtaxing foreign income, the United States is going to exempt domestic income from

tax. This enables other countries to continue overtaxing at the expense of our Treasury, because ultimately the game is not between the companies in the United States, it is between the governments.

They are really taking U.S. tax revenues. To the extent this moratorium is continued, it will remove the incentive of companies to complain about or try to alleviate discriminatory tax abroad. Therefore, a situation in which they have gotten into through no fault of their own will probably continue, other countries will overtax their foreign income, we will undertax their domestic income, and nobody will complain about it.

I think you should view what people say about the moratorium with the idea that relocation turns very often on extremely technical issues that nobody talks about, what 861 allocations will be in the foreign country, can you move research facilities abroad without tax, what policy will the country have that gives you the deduction about requiring royalties to be paid from the United States?

I think these issues are very important. I think the most important issue is overtaxation abroad—and it is such overtaxation rather than particular incentives that this moratorium is about. Foreign countries may hope that the U.S. companies will relocate the facilities, but in any event they want to overtax American-owned companies because it increases their tax revenue at the expense of a foreigner.

So the ultimate question is whether discriminatory taxation will continue and, if so, will anybody here complain about it. They will not if we take care of them by exempting domestic income from tax.

Thank you.

[The prepared statement of Mr. Kingson follows:]

STATEMENT OF CHARLES I. KINGSON, WILKIE, FARR & GALLAGHER, NEW YORK, N.Y.

CONTEXT AND BACKGROUND OF THE SECTION 861 REGULATIONS

What the section 861 regulations do

Foreign source taxable income is calculated by first classifying the items of gross income that are from foreign sources and then subtracting from foreign gross income the deductions attributable to those items. Section 861 of the Code classifies gross income as from either United States or foreign sources. Treasury Regulations section 1.861-8, commonly referred to as the section 861 regulations, allocates deductions between gross income from the United States and that from foreign sources.

Both the statute and regulations thus serve the same purpose—determining foreign source taxable income. To the extent the section 861 regulations allocate deductions (such as research expenditures and interest payments) to gross income from foreign sources, they reduce foreign source taxable income.

Relevance of the section 861 regulations to the foreign tax credit

American companies generally want the highest possible percentage of their taxable income to be classified as foreign. This is because section 904(a) of the Code limits the amount of foreign tax that an American company can credit against United States tax to the following product: Foreign source taxable income divided by total taxable income multiplied by U.S. taxes.

Assume, for example, a United States corporate tax rate of 50 percent. Assume further that an American company had the following ordinary income and paid the following taxes:

	United States	Foreign
Income	100	100
Taxes	50	60

The limitation fraction would be as follows: (Foreign income) 100 divided by (Total income) 200 multiplied by (U.S. taxes before credit) 100 equals 50.

The corporation would therefore owe \$100 of U.S. taxes, against which it could offset \$50 of foreign tax credit. It would therefore owe the same \$50 of United States tax—no more and no less—than if it had not had any foreign source income.¹

A simpler way of viewing the limitation, consistent with its objective, is that the credit is limited to the United States on foreign source income.² Assuming for convenience a United States corporate tax rate of 50 percent, the foreign tax credit limitation becomes 50 percent of foreign source taxable income.³

Equivalence of excess credit to exempt income

When foreign taxes paid equal or exceed 50 percent of a United States company's foreign source taxable income, such income becomes effectively exempt from United States tax: that is, United States tax will not be payable on foreign source income.⁴

The section 861 regulations, therefore, perform the same function as does section 265 of the Code, which disallows deductions attributable to income that is literally exempt from United States tax. To illustrate the similarity to a disallowance, assume that a United States company has the following income and taxes, before allocation of a \$20 deduction for research expenses:

	U.S. income \$100	Foreign income \$100
Foreign taxes	0	50
U.S. taxes	50	0

Note.—50, minus 50 foreign tax credit.

The foreign tax of \$50 is equal to the U.S. tax imposed on that income. Accordingly, no U.S. tax is imposed on that income, and the foreign tax credit limitation (50 percent of \$100 foreign source income) has been reached. The foreign income is therefore effectively exempt from U.S. tax.

If the \$20 of research expense deduction is allocated to United States income, the result will be:

	U.S. income \$80	Foreign income \$100
Foreign taxes	0	50
U.S. taxes	40	0

If to foreign income:

¹ If it had had only the \$100 of United States source income, its United States tax would have been \$50.

² The objective of such limitation, as set forth in a Joint Committee Staff pamphlet, is to prevent foreign tax credits from being used "to offset U.S. tax on domestic income".

³ This can be shown by rearranging the statutory formula in four steps.

(a) Foreign income multiplied by U.S. taxes divided by total income.

(b) Foreign income multiplied by U.S. taxes divided by total income.

(c) U.S. tax divided by total income equals effective U.S. tax rate.

(For a large corporation—assuming a 50 percent statutory rate—the effective tax rate is about 50 percent of taxable income. The reason is that, for this purpose, United States tax is calculated before reduction for such items as the investment tax credit and the foreign tax credit itself.)

(d) Foreign income times 50 percent, or 50 percent of foreign income.

⁴ The equivalence can be shown by recent amendments affecting United States companies operating in Puerto Rico. Prior to 1977, their income was literally exempt from United States tax; since 1977, their income obtains a foreign tax credit equal to the United States tax on such income—i.e. 50 percent times Puerto Rico taxable income. The effect is the same.

	U.S. income \$100	Foreign income \$80
Foreign taxes	0	50
U.S. taxes	50	0

Allocation of the deduction to foreign income therefore just reduces the amount of income that is exempt from tax anyway, and the deduction does not benefit the company.⁵

Until the foreign income becomes exempt from United States tax, however, deductions allocated to foreign income benefit a company just as much as deductions allocated to United States income. To illustrate, assume the following situation:

Foreign income	\$120
Foreign tax	50
U.S. tax (\$60 less \$50 foreign tax credit)	10

Assume next that \$20 of deductions for research expense are allocated to foreign income. The situation becomes:

Foreign income	\$100
Foreign tax	50
U.S. tax	0

The allocation of \$20 research expense to foreign income has not hurt the taxpayer. It has saved him United States tax of \$10, because before the allocation the foreign income was not exempt from United States tax.⁶

The moratorium as exempting income from tax

To the extent that American companies with potential excess foreign tax credit can get income classified as foreign rather than domestic, they can exempt it from United States tax. Congress has previously cut back on the ability of companies to obtain such exemption by using section 861 of the Code to classify gross income as foreign.⁷

The section 861 regulations are equally as important as the rules classifying gross income as United States or foreign, because—as previously stated—together they determine how much foreign source taxable income a company has. They therefore ultimately present the same issue: whether income which is economically attributable to the United States is to be exempt from tax.

Assume also that the company invests enough in banks to produce \$20 of interest. If invested in United States banks, the \$20 would be U.S. source income on which \$10 United States tax would have to be paid. If invested in foreign banks, it is foreign source gross income. Since this would raise the foreign tax credit limitation to \$60 (50 percent of \$120), investing in foreign banks would produce tax-exempt income. The illogic of this result, as well as its unfairness to domestic banks, caused Congress to change it in 1962.

Much the same result occurred if the company had a \$20 gain on, say, 100 shares of General Motors stock. If the stock were sold in the United States, the gain would be subject to United States tax; if sold abroad, it would be foreign source gross income and therefore exempt from tax. Congress changed this in 1976, so that the \$20 gain does not increase the foreign tax credit limitation.

	U.S. income \$100	Foreign income \$100
Foreign tax	0	50
Tentative U.S. tax	50	0

⁵ Although the Code provides for carryovers of the \$10 foreign tax paid in excess of the \$40 limitation (50 percent times \$80), the carryover does no good if—as is frequently the case—excess credit is a chronic condition.

⁶ After allocation of the \$20 expense, the foreign income has become exempt from United States tax; and a further allocation of, say, \$10 of research expenses to foreign income—although reducing the foreign income to \$90—cannot reduce the United States tax on such income below zero.

⁷ Assume: Foreign business profits, \$100; Foreign tax paid, \$60.

Assume further that a \$20 deduction for research expenditures, although incurred in the United States, is on a proper cost accounting basis attributable to foreign sales. To attribute that deduction to the United States reduces United States income to \$80. In other words, it exempts from tax \$20 of United States source income.

A less complex way of viewing what this moratorium is about is to consider the case of an American living abroad who earns \$100 in fees and incurs \$20 of business expense in doing so. His other income consists of \$20 of dividends from General Motors. The Code exempts from tax his earnings, but not his dividends. Under section 265 of the Code, he is considered to have \$80 of exempt earnings (\$100 minus his business expense) and \$20 of taxable dividends. What the moratorium would do—if applicable to him—is reallocate the \$20 business expense from his nontaxable fees to his taxable dividends. As a consequence, because of an expense applicable to his fees, both the fees and the dividends would be exempt from United States tax.

History of the 861 regulations

Until 1973 the section 861 regulations were minimal, saying only that you attributed deductions to the proper income. In that year regulations were proposed which would have allocated research expenditures in accordance with the percentage of sales—including expected sales—here and abroad. To illustrate, if there were research expenditures of \$100, and it was expected that ultimately 50 units of the product would be sold abroad and 50 in the United States, one-half—\$50—of the deduction would be allocated to foreign income.

Companies objected to the proposed regulations, for several reasons. Among them were the following:

1. To use expected sales abroad was unfair, since this did not give an appropriate discount to the fact that profits from sales abroad would be earned later than profits from sales in the United States;
2. Economically, companies did research primarily for the United States market; so that the bulk of that expenditure should be traced to United States income rather than apportioned as if the two markets were fungible;
3. It would be unfair to allocate to foreign income more research deductions than the income obtainable from licensing such research; and
4. Apportioning the deductions in such a way that they were as a practical matter disallowed would encourage companies to relocate research facilities abroad, where foreign countries would allow a tax deduction to reduce tax.

The first two arguments are economic ones, which I do not intend to discuss. From a technical point of view, however, they appear to assume that income from the research activities attributable to United States sales will be taxed by the United States, whereas in fact much of it goes untaxed because the patent is transferred to a corporation with operations in Puerto Rico.

The third argument, which is extremely persuasive, can be illustrated by an example. Assume \$100 of research expense, and that sales of the product will be one-half in the United States, where United States parent P manufactures and distributes it; and one-half abroad, where P's foreign subsidiary F makes and distributes it. Assume further that the foreign tax rate on F's income is 50 percent.

Each company has \$150 of profit before deduction of royalties or research expense, and F declares all its after-tax profits as a dividend. The foreign country where F manufactures, however, only allows a \$30 deduction for royalties to P.

Income of F.....	\$150
Less royalty to P.....	30
Total.....	120
Foreign tax.....	60
After-tax profit (remitted as a dividend to P).....	60

INCOME OF P

	U.S. income \$150	Foreign income \$30 royalties
Less allocation of the one-half research expense.....	(50)	(50)
Plus dividend.....		¹ 120
Net income.....	\$100	\$100

¹ This includes the \$60 cash and the \$60 of foreign tax deemed paid by P for foreign tax credit purposes.

In other words, because F could not reimburse P for \$20 of technology expense which the proposed section 861 regulations would have allocated to F, F's income is \$20 greater for foreign purposes than it is for U.S. purposes. Even though the U.S. and foreign tax rates are the same, the foreign base is higher—\$120 rather than \$20. As a result, the total tax paid on \$200 of combined profit is \$110; and the extra \$10 is paid because the United States allocates \$20 more of deductions to F's income than does the foreign country.

Foreign countries have legitimate and not-so-legitimate reasons for restricting the amount of royalties F can pay P. The legitimate one is that F is benefiting from past research, the value of which may not equal current expenses. The not-so-legitimate are that the limit increases the foreign country's tax revenues and that such taxation might encourage P to shift some research facilities abroad. But to shift research facilities abroad for tax reasons is to enter a tax quagmire—discussed below—which can best be likened to playing three-cushion billiards.⁸

Present section 861 regulations

As adopted in 1977 and as still in effect (without regard to the statutory moratorium), the section 861 regulations recognized the companies' arguments—especially the third—by permitting allocation of research expenses incurred in the United States in accordance with a United States company's relative percentages of foreign and United States gross income, rather than sales.

Foreign source gross income often represents a small percentage of total gross income, for two reasons. One is that not all foreign profits are remitted as dividends to the parent. Second, United States gross income is measured before expenses such as interest, research, marketing and administration, whereas gross income from foreign subsidiary dividends is taken into account *after* such expenses.⁹ For that reason the regulations require that the gross income allocation must result in at least half as much being allocated to foreign income as would the following two-step allocation (which is available as an alternative): One, 30 percent to the United States; two, the remaining 70 percent in accordance with the percentages of foreign and United States sales.

Thus, assume that research expenses are \$100 and that expected sales are one-half abroad and one-half in the United States. Under the two-step allocation, \$30 will first be allocated to United States income; of the remaining \$70, \$35 will also be allocated to United States source income and \$35 to foreign source income. An allocation based on relative percentages of gross income requires that at least one-half the \$35, or \$17.50, be allocated to foreign source income.

Thus, in the situation where one-half the expected sales will be foreign, the 1973 proposed regulations allocated \$50 of each \$100 in research expense to United States income; the final regulations allocated up to \$82.50 to United States income; and in many cases, therefore, the moratorium concerns only allocation of the final \$17.50.

Shifting research facilities abroad

Assume—using the above example, where one-half the sales are foreign—that the present section 861 regulations allocate only \$17.50 of every \$100 of a United States parent corporation's research expense to foreign income.¹⁰ So long as foreign coun-

⁸ Moreover, research does not take place *de novo*; and it is unclear whether the United States tax authorities would permit the accumulated know-how necessary for further research to be transferred to foreign subsidiaries without payment of a substantial tax. Section 367(a) of the Code. If it were not transferred, the United States might insist on payment of a royalty for such know-how, which the foreign authorities might not allow.

⁹ To illustrate:

	P	F
Gross receipts, less cost of goods sold	\$1,200	\$1,200
Research, interest, etc	(600)	(600)
Net income	600	600

If the subsidiary distributed \$200 of its \$600 profit to the parent, the parent's foreign gross income would be \$200, which is only one-sixty of its United States gross income of \$1,200.

¹⁰ If foreign sales were only one-fourth of total sales, the allocation of United States-incurred research expenses to foreign income could be as low as \$8.75 per \$100.

tries allow \$17.50 of deductible royalties to be paid to the United States parent, a tax advantage in shifting research activities abroad exists only to the extent that (a) withholding tax is imposed on foreign royalties paid to the United States parent and (b) the jurisdiction to which the research is shifted allocates a smaller percentage of research expense to foreign royalties than the section 861 regulations allocate to foreign income—in this example, 17.5 percent.¹¹

Thus, assuming \$17.50 of deductible foreign royalties and no foreign withholding tax, there is no tax advantage in shifting research abroad. To illustrate, assume that the foreign tax credit situation of United States parent corporation P is such that its foreign income is exempt from United States tax. P has \$100 of United States income, and its foreign subsidiary F has \$100 of foreign income. Before research expenses and royalties, the situation is as follows:

	P	F
Income	\$100	\$100
Foreign tax	0	50
U.S. tax	50	0

Note.—Total tax \$100.

Assume that P has \$100 of research expense. If it were all allocated to United States source income, P would save \$50 in United States taxes. If F conducted the research and deducted the \$100, F would save \$50 in foreign taxes.

If, however, P can charge F a royalty equal to the amount of the \$100 research expense which the section 861 regulations allocate to foreign source income—in this example, \$17.50—a total of \$50 in tax is saved anyway. The situation becomes:

	P	F
Income before royalty	\$100.00	\$100.00
Foreign royalty	(17.50)	(17.50)
Research expense	(82.50)	(17.50)
Net income	17.50	82.50
Foreign tax	0	41.25
U.S. tax	8.75	0

Note.—Total tax \$50.

The combination of deductions and royalty, therefore, has saved the same \$50 in total tax as would have either allocating all the research deductions to United States source income or conducting the research in the foreign country.

The situation becomes more complex when foreign withholding tax is imposed. To illustrate, assume the same facts as the previous example, except that F's country imposes a five dollar withholding tax on royalties paid either to the United States or to the foreign country to which the research facilities are shifted—say, Germany. If the research facilities remain in the United States, the total tax paid will be \$55—the original \$50 plus five dollars of country F withholding tax. The reason for the increase is that country F tax has not reduced United States tax.

Now assume that the research facilities are shifted to German company G, which has the same \$100 of domestic income and \$17.50 of F royalty as P.¹² To the extent

¹¹ This assumes similar United States and foreign country corporate tax rates.

¹² This does not take into account royalties which P must pay to G, the amount of which is difficult to predict. Suppose, for example, that a United States corporate group had three-fourths of its sales in the United States, and one-fourth of its sales in Germany. If it relocated its research activities to Germany, it would save German taxes only to the extent that the sum of (a) the royalty which Germany currently allows to be paid to the United States parent and (b) the royalty which the German tax authorities would require to be paid from the United States parent exceeded (c) the current year's research expenses.

For example, assume that United States parent P has \$100 of research expense. P's German subsidiary G has income of \$110, from which it is allowed to deduct a \$10 royalty to P. Its net income is therefore \$100, on which it pays \$50 of German tax.

If G were to do the research instead of P, there would soon be no reason for G to pay P a royalty. G's operating income would therefore be \$110, from which it would deduct the \$100 of research expenses, leaving \$10 of net income. To the \$10, however, must be added the royalty

Continued

that G pays less than \$8.75 of German tax, it will have paid less tax than P would have. If G can credit the entire five dollars of F country withholding tax against German tax, it will owe only \$3.75 in German tax (50 percent of \$17.50 less five dollars). Total tax for the group will again be \$50 (\$41.25 of F company tax, five dollars of withholding, and \$3.75 of German tax); and the cost of the withholding tax will have been eliminated. Conversely, if Germany allocates more than \$7.50 of research expense to the F royalty, some part of the credit would be disallowed. (Once five dollars of tax has been paid on a net royalty of ten dollars, any further allocation just reduces exempt income.) At an allocation of \$17.50 the credit for F tax disappears, since G then has no taxable foreign income.

Accordingly, assuming a reasonable level of foreign royalties, the tax advantage of shifting facilities abroad depends on both the existence of substantial withholding tax imposed by third countries and a smaller allocation of expense to foreign income in the country of relocation.

The current situation

The excess foreign tax credit situation from which the moratorium seeks relief comes about for a variety of reasons. These include the overall foreign tax credit itself, the United States inability to obtain tax treaties reducing the taxes of developing countries, and the variety of taxes which the United States considers creditable.

To a significant degree, however, it occurs because countries like Germany, France, and Canada discriminate against United States-owned companies. Germany is well-known for its limiting the deduction of royalties; Canada and France openly permit locally-owned companies a larger deduction for interest paid to shareholders. Added to this discrimination as to the tax base is discrimination as to the tax rate. All three of those countries give part of the corporate tax back to local shareholders, but not to United States parent companies. In considering the moratorium, it should be recognized that the companies' plight arises in part from failure of the government to protect them from discriminatorily high taxes.

The question, however, is whether—because foreign countries overtax foreign income—the United States should undertax domestic income. In effect, the United States is transferring its tax revenue to the discriminating countries. The real contest is between governments, not between the United States and its corporations.

If the moratorium were made permanent, it would remove the incentive of many companies to press for a change in the situation, by treaty or otherwise. Because of the necessity of such companies to do business in other countries and the possibility that the moratorium will be made permanent, it is unlikely that the moratorium has encouraged them to press for less discriminatory taxation.

A widespread perception exists that tax treaties are a giveaway to the multinational companies. For example, Congressional criticism of the pending treaty with Canada was not that we did not sufficiently limit Canada's discriminatory taxation of foreign investment, but that the treaty did not permit enough taxation of foreign investment. So long as we have more investment abroad than foreigners have in this country, it is in the interest of the United States to limit each country's taxation of foreign investment—particularly when such taxation is discriminatory. To the extent that we do not limit their tax on income earned abroad, we will end up—as this moratorium indicates—by limiting our tax on United States income.

Mr. DORGAN. Thank you, Mr. Kingson.

Mr. Anthony?

Mr. ANTHONY. I just have one question, Mr. Chairman.

I forgot what it was like to be back in law school, listening to a tax professor, and I almost went to sleep like I did in the past.

which G would be required to charge to P. If that royalty were \$90, G would again have \$100 of net income and owe German tax of \$50.

Tax saving from performing research in Germany, therefore, might have to come from the allowance of royalty deductions by countries other than Germany. In this example, if \$90 were a fair royalty for three-fourths of the sales, then Germany should have allowed a \$30 royalty for one-fourth the sales. The ultimate tax saving, therefore, is a United States tax saving; and it occurs because the United States allows a greater deduction for royalties than did the country to which the research was shifted.

How much royalty income Germany would impute and third countries would allow would depend on such factors as national tax policies and the value of the technology which the research produces, both of which may be difficult to predict. Moreover, since the tax result depends to some extent on policies other than those of the country of research, moving facilities abroad resembles the game of three-cushion billiards.

I have one simple question. Are you for a rewrite of 861, or do you think that we ought to do something different? You gave a beautiful analysis, but you didn't help me decide how I wanted to vote.

Mr. KINGSON. I think that I intended it to be technical rather than to come out with a conclusion.

I gave the tax analysis. There are people who believe—as they do with every tax measure—that this will save America. I have no idea about its effects on jobs or trade and what the tradeoff is.

But as a tax analysis, I think that because other countries discriminate, for us to exempt U.S. income in response is something that would have to be weighed against the benefits of keeping the jobs here or, you know, expanded research and development.

Mr. ANTHONY. So you are basically saying that we are going into the unknown versus the known; the known being that we are obviously going to have loss of revenue, and how far can we stand that before we are willing to say, we better take another look at it.

Mr. KINGSON. Not only loss of revenue, but loss of incentive to stop discriminatory tax practices of other countries. If we could pay more royalties back from other countries—and in my practice I have heard a lot of complaints about other countries not allowing royalties—in some circumstances this excess foreign tax credit limitation would not exist.

Mr. ANTHONY. You are saying that we should continue to monitor what other countries do as far as taxation of domestic companies abroad in regard to our 861 regulations, and then monitor the results against the benefits of jobs created, products coming on line and the cost to the Treasury.

Mr. KINGSON. Yes.

Mr. ANTHONY. As always, you will leave it up to the politicians to vote and determine the difference.

Mr. KINGSON. Right.

Mr. ANTHONY. That is fair enough.

Mr. DORGAN. Mr. Thomas.

Mr. THOMAS. No questions, Mr. Chairman.

Mr. DORGAN. Mr. Kingson, it is a complex issue. It appears to be at first blush a relatively simple thing, the question of how we allow corporations to allocate or apportion various expenses in the various streams of income to the company.

As you indicated in your statement, it is eminently more complex than it appears at first blush.

I have not made a determination about how I feel on the issue. There are a lot of considerations.

Mr. Shannon raised the issue of jobs which we are all concerned about. We don't want to develop tax policy that just indiscriminately persuades those who want to engage in R&D to do so outside the United States.

We want to, in fact, encourage that to be done here in this country. I think that you raise some interesting points in your testimony and you talk about discrimination by foreign governments of multinationals that have subsidies there.

If we would allow allocation of research and development funds to this country in excess of those which would normally be attached to some reasonable description of divided income from the

corporation, would that not have the effect of overstating the corporation's foreign income, and if it overstates the foreign income, would that not then lead that foreign government that you say discriminates to get a larger share of the income tax than they should at our expense?

In other words, is the effect of this an unintended and unfortunate revenue sharing between the U.S. Federal Government and some other national government that is discriminating?

Mr. KINGSON. I believe it is to the extent it removes the incentive of these companies to protest that and ask the Treasury to remove that discrimination.

Mr. DORGAN. Can you review—I know you have it in your paper—but can you review how that discrimination manifests itself in Germany or Canada and how it developed and why the multinationals who have such a substantial impact on tax policy in this country and especially on this committee, very frankly, have not had that same impact in Canada or Germany, at least according to your testimony?

Mr. KINGSON. Well, Canada and Germany—and both do not allow Canadian and German subsidiaries of U.S. corporations the same deduction for interest and royalties paid to their shareholders—interest in the case of Canada and royalties in the case of Germany.

This increases the German and Canadian taxable income beyond what a Canadian company's taxable income would be and beyond what an American company's taxable income would be if under U.S. principles interest or royalties were paid to foreign shareholders.

Therefore, even if Canada and Germany have the same tax rate as the United States they have a higher tax than would the United States because they apply it to a higher taxable income. Added to the fact is that both Canada and Germany have high corporate tax rates. They give part of the corporate tax back to shareholders when dividends are declared, but they give it back only to Canadian or German shareholders.

They don't give it back to U.S. shareholders. So the fact is to the extent they are taxing a higher amount of income to U.S.-owned companies and applying a higher rate of tax to U.S.-owned companies, they are, in effect, discriminatorily taxing them. Moreover, in order for companies to have excess foreign tax credit, they must be paying more foreign tax on their foreign income than any U.S. tax payable without investment credit on ACRS.

To the extent that we shield multinationals from this overtaxation by misallocating under the 861 regulations, the multinationals—since they don't care whether they give the money to Canada or the United States as long as it is the same amount—will have no incentive to protest against the discrimination. They have substantial difficulty in protesting since they have subsidiaries in the discriminating country and don't particularly want to be seen as pressing the Treasury to retaliate or to take some action against the country or its national's U.S. subsidiaries. So, they have every reason not to protest, especially when 861 regulations have largely protected them from the problem.

When you are talking about \$100 of research expense, the proposed regulations said if half your sales were abroad, you allocated \$50 to foreign source income. The present regulations, if half your sales are abroad, allows only \$17.50 to foreign source income, and if only a quarter of your sales are foreign, as little as \$8.75 out of \$100 of research expenses must be allocated to foreign source income.

For a company with one-fourth of its sales abroad, we may be talking about—if its foreign gross income is lower, this moratorium is affecting \$8.75 of \$100, which the 861 regulations would now allocate to foreign income.

Mr. DORGAN. Do you generally concur with Mr. Shannon's recommendations to the committee?

Mr. KINGSON. I think that that recommendation is based on economics, which is not the subject of my testimony. I think the issue is a question of weighing exempting U.S. income from tax and removing the incentive to stop discrimination, versus jobs and relocating facilities abroad.

But I think it is very important that you be aware—be conscious of what decision you are making and that relocating abroad is a very complex tax decision, the consequences of which may be quite unknowable at this time.

Mr. DORGAN. Is that a lengthy euphemism for "it is bad tax policy" in your opinion? I understand what you are saying about the economic issues and I am mindful of them and concerned about them, but I get the feeling in your answers to Mr. Anthony and your answer now that you think this is probably bad tax policy.

Mr. KINGSON. I would prefer not to take a direct stand on that.

Mr. DORGAN. All right. Well, I appreciate your concern and we appreciate your very thorough presentation that sets out some very important issues for us.

I think all of us are concerned about trying to encourage and continue research and development activities in this country.

I have not made a decision on this issue. I expect many people have not either. We are trying to sift our way through to find out not only good tax policy, but what makes good sense for the country.

Mr. Thomas.

Mr. THOMAS. I understand your concern and the reason you appear today. Perhaps you don't want to reveal it publicly, but I just, frankly, think you owe me a yes or no on that last question if we meet later someplace else.

I will push you a little harder maybe then. Many of us don't have the experience and knowledge, and we cannot weigh it as you weigh it. We appreciate your going through it and the problem is ultimately we have to make a decision.

Mr. KINGSON. I understand, but in a sense you have to make a decision based on factors beyond my expertise. Although I can see the tax issues, I have no idea whether, in fact, companies have an intention of relocating abroad, whether it will discourage jobs in the United States, whether it will do all the things that Mr. Shannon fears it will do if you don't renew the moratorium.

Mr. DORGAN. If I might interpose for a second, Mr. Thomas. Mr. Kingson was an invited witness for the committee for the purpose

of giving background information and I expect he has a number of considerations that would lead him not to want to make known a permanent position of his.

I would encourage you to meet him afterwards and have a cup of coffee and—

Mr. THOMAS. I made him that offer. He has not said yes or no.

Do you know someone who can make that kind of decision and weigh the choices which you indicated are necessary in terms of reallocation?

Mr. KINGSON. I think that the question about the jobs, I think it is an unknowable factor. The question is, how much money and how much are you willing to give up on that possibility?

I think that you should weigh with some skepticism the idea that I am going to relocate abroad and get the deduction without getting the income and without knowing their 861 policy.

Mr. THOMAS. If I might pursue that, even including people engaged in the business who tell us, based on their financial statements, they have made that decision.

Mr. KINGSON. I would be very curious. I have been to many seminars given by accounting firms with their foreign partners and one of the things I asked them, the foreign partners, is what is the 861 policy of your country?

They have difficulty in articulating it. I think that because our foreign investment has exceeded that of other countries, we have focused on the section 861 issue before the other countries have.

I think that if you were to—if you were to divide the companies up, they are not monolithic. They may come in advocating a moratorium because it helps everybody, but the ones who do not have substantial withholding taxes—for example, the ones who get their dividends from Germany and Netherlands or the United Kingdom where by treaty there are no withholding taxes as opposed to getting them from France, Canada, or the developing countries—they probably have very little incentive to relocate abroad, when, as my example indicates, they save \$50 worth of tax for every \$100 of research expense.

Companies that do not get \$50 worth of tax benefits because of withholding tax on employees, may decide to relocate abroad. But that decision probably depends upon the IRS letting them do so without constituting a taxable sale upon the 861 policies of the foreign country to which they locate, and upon how much royalties the foreign country will require them to charge for the research. That, in turn, depends on how good the technology will be, what the foreign country's policy will be, and what our policy will be.

I think it is a very complex decision. To say that if you don't give us a moratorium, we will relocate because we get a deduction if the foreign country just begins the analysis.

The companies that appear here will be in very different positions, depending on the amount of withholding, where they have to relocate and where or how much know-how they have to transfer abroad.

I am sorry I cannot give a yes or no.

Mr. THOMAS. Thank you, Mr. Chairman.

Mr. DORGAN. We have other witnesses who will talk about tax policy and give us judgments of theirs about whether or not this is

good tax policy. We didn't mean to put you on the spot, you volunteered to come forward and give us the technical background and you demonstrated those skills under these latest questions that would probably give you the capability of running for office successfully.

Mr. KINGSON. Mr. Dorgan, I don't know about that.

Mr. DORGAN. Thank you very much, Mr. Kingson.

Mr. DORGAN. We will next call on Mr. Chapoton.

Mr. Chapoton, Assistant Secretary of the Treasury. We welcome you, sir.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman. I will be brief, because I think Mr. Kingson has made some of the points I would have had to cover. But I think this discussion we have just had has focused the question to the core point that the committee will have to consider and that we at Treasury and in the administration are going to have to consider.

First, let me say that I am happy to be here to present the Department's views and the administration's views on this question of the allocation of the cost of R&E performed in the United States to domestic source income.

The allocation of domestic source R&E to domestic source income solely as required by the moratorium produces a tension between two policy objectives, as Mr. Kingson's testimony and the questions following made clear.

On the one side, it is promotion of domestic R&E to strengthen the competitive position of the U.S. economy in world markets. The other side is the objective of U.S. tax policy to preserve the tax base by limiting the credit for foreign income taxes to the amount of U.S. tax which would be paid on the foreign income, thereby preventing foreign taxes from reducing U.S. tax on U.S. income.

As I think Mr. Kingson pointed out very well, the code even before the present 861 regulations has clearly required taxpayers to allocate and apportion R&E expenses and other expenses between the income from domestic and foreign sources related to that expense.

The moratorium which came in in 1981, of course, required 100 percent allocation of R&E to domestic source income and told the Treasury to produce a study on the effect of the allocation, which was done and released in June of this year.

Let me say at the outset that the administration is firmly committed to encouragement of productivity enhancing private sector R&E and for this reason we have supported a further 2-year extension of the ERTA suspension of the allocation of R&E abroad so that the results may be considered further and that we may identify the alternatives to be included in a coherent national program.

That is what this committee needs to do and that is what we need to do. I will forego the part of my statement, Mr. Chairman, in the interest of time, that covers the points covered by Mr. Kingson that basically show clearly that the allocation of this expense,

like the allocation of any expense, is required from a tax policy ground or from a correct measurement of income ground.

We can argue about whether the specifics of the allocation are correct or sound as a matter of accounting, but I think that we ought to brush that question aside for the time being at least and get to the more significant questions.

We think the R&E regulations are an objective attempt to satisfy the statutory requirement. I heard Mr. Shannon say he thought the regulations were unsound in some respects—that is not a generally held view.

We have heard very little complaint about the technical aspects of the regulations, that is that they require the allocation of too much abroad if you decide that some allocation abroad is required.

The point that Mr. Kingson didn't get into in as much detail, that I want to make here, is that the companies that are benefited by the moratorium are those that are in excess credit position.

I think he said that, but that bears emphasis because you have to see whether this incentive device works correctly. It does not benefit companies that have a low foreign tax rate on their foreign income. It, instead, benefits those with high effective foreign tax rates either because of the statutory rate or, as Mr. Kingson points out, because of the disallowance of deductions which we would allow on income earned abroad. The effect is the same; there is a high foreign tax rate on the foreign income.

The companies that build up excess foreign tax credits are the companies that are affected by the allocation of R&E abroad.

U.S. corporations can rightfully claim they are disadvantaged by the refusal of foreign governments to recognize R&E deductions or cost sharing payments performed outside of their country even though related to income produced and taxed in their country.

I think Mr. Kingson made the point clearly that that is a valid complaint, and the question is whether you satisfy that complaint and that discrimination by making a change in U.S. tax liability.

When we analyze it, as this committee is now doing, we come to the conclusion that the suspension of allocation of R&E abroad should not be analyzed as an attempt to correctly measure source of income, but it should be analyzed as a tax incentive to encourage domestic R&E so the question we must decide and you must decide is, is it an effective incentive to encourage domestic R&E or is it not an effective incentive?

That was part of the purpose of our report. We found in the report that, had the regulation been in effect in calendar 1982 instead of being suspended by ERTA, U.S. tax liabilities of U.S. firms would have been \$100 million to \$240 million higher than they were as a result of the suspension.

New data that we have since that report was released in June—that is data on the excess credit positions of the companies involved—indicates that the lower end of the range is our best estimate of the cost of the suspension. That is, around \$100 million is the revenue cost from the moratorium in calendar 1982.

As we project that forward, we find that a 2-year extension would cost approximately \$120 million and \$133 million in 1984 and 1985, respectively.

An appraisal of the ERTA suspension as an R&E incentive depends in no small part on how it affects different taxpayers and, as I mentioned, it does not affect taxpayers uniformly. It only reduces the tax liability of those firms that are in excess credit positions so it depends on that factor, on the firm's foreign operations, and not on the level of its R&E effort.

The information that we have developed also shows that the regulation has its most significant effect on large multinational companies as opposed to the relatively small high tech companies.

There are a number of reasons for this in our statement, and they are pretty obvious when some thought is given to them. The \$100 million to \$240 million higher tax liabilities in 1982 that would have occurred absent the moratorium would have increased the cost of privately financed R&E activity we estimate by less than one percent.

If we use the \$100 million tax figure for increased 1982 liabilities absent the moratorium which now, as I stated, is our best estimate, we calculated a reduction in R&E in 1982 of from \$40 million to \$110 million.

The higher costs reduce R&E to some extent and our estimate is that the reduction would have been \$40 million to \$110 million. We think most of the reduction would have occurred because domestic R&E is somewhat more expensive rather than a transfer of R&E activities from domestic to foreign locations.

Any reduction in R&E will affect employment in the industries but it is impossible to determine how much employment would be affected. Offsetting adjustments take place in the U.S. economy as a result of any policy change so it is difficult and often impossible to determine the macroeconomic consequences of policies which have a highly concentrated effect on a relatively narrow range of firms and industries.

Thus the problem of R&E allocation is not primarily of finding out how best to increase aggregate employment in the short run but how to design an appropriate incentive to increase productivity and expand employment opportunities in the long run.

We recognize that any reduction in R&E may adversely affect the competitive position of the United States and because of the importance of the R&E and the competitive position of the U.S. economy, it is essential that the Federal policy be designed so that the resources available to finance Federal incentives encourage the maximum in R&E and innovative activity.

For these reasons we support a 2-year extension of the suspension of the allocation of R&E expenses abroad. We want to consider the question that you have been discussing and want to work with you to address that question. We suggest we give ourselves 2 years to look at it.

Thank you, Mr. Chairman.

[The prepared statement and a report prepared by the Department of the Treasury on regulation 1.861-8 follow:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY),
DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to participate in your review of Federal policies affecting research and experimentation (R&E). This morning I will present the views of the Treasury Department on the subject of the allocation of the cost of R&E performed in the United States to domestic source income. I would like to first direct my remarks to the basic policy considerations raised by the allocation of R&E expense solely to domestic source income and then discuss some of the technical aspects of the 1.861-8 regulation (the Regulation).

I. Policy Considerations

The allocation of domestic R&E expense solely to domestic source income produces a tension between two important national policy objectives. One is the promotion of domestic R&E to increase U.S. productivity and strengthen the competitive position of the U.S. economy in world markets. The other is the objective of U.S. tax policy to preserve the U.S. tax base by limiting the credit for foreign income taxes to the amount of U.S. tax which would be paid on foreign income, thereby preventing foreign taxes from reducing U.S. tax on domestic income.

The Internal Revenue Code requires taxpayers to allocate and apportion R&E expense between the income from domestic and foreign sources related to the expense. Regulation 1.861-8 provided taxpayers with specific guidance on how to make the

allocation and apportionment required by the Code for R&E and other expenses. Section 223(a) of ERTA suspends for two years the application of the Internal Revenue Code provision and the Regulation's R&E rules insofar as they relate to the allocation or apportionment of R&E expense to foreign source income. In addition, section 223(b) of ERTA directs the Treasury Department to study the impact of the Regulation on R&E conducted in the United States and on the availability of the foreign tax credit. The report on that study was presented to the Congress in June, 1983.

A. Administration Support of Private Sector R&E

This Administration is firmly committed to the encouragement of productivity-enhancing private sector R&E. In a time of fiscal stringency, however, we must carefully analyze the cost effectiveness of alternative R&E incentives. Federal resources available to encourage private sector R&E are finite. Thus, the Administration has supported a further two-year extension of the ERTA suspension of the Regulation's R&E rules so that the results of the Treasury study may be considered in identifying alternatives to be included in a coherent national program of R&E incentives.

Before reviewing the findings of the Treasury Department's Report on the section 1.861-8 Regulation, I will discuss the Regulation and how it interacts with the foreign tax credit limitation.

B. Foreign Tax Credit and Credit Limitation

Domestic corporations, U.S. citizens, and aliens resident in the United States are subject to U.S. tax on their worldwide income. If income earned by a U.S. taxpayer is derived from sources outside the United States, it also may be subject to tax in the country in which it originates. If the same income is taxed in both the residence (United States) and source (foreign) jurisdictions, double taxation will result. To alleviate this result, the United States permits its taxpayers to elect to credit foreign income taxes (or taxes in lieu thereof) paid to a foreign government against their U.S. income tax liability. Under the credit, the United States cedes primary taxing jurisdiction to the source country.

The foreign tax credit provides U.S. taxpayers with a dollar for dollar reduction of, or offset against, their U.S. income tax liability. The credit is available for foreign income taxes (or taxes in lieu thereof) paid on foreign branch income, withholding taxes (on such items as dividends, interest, and royalties from a foreign corporation) and, provided the U.S. taxpayer is a corporation which owns at least ten percent of the voting stock of the foreign corporation, the corporate tax on the underlying earnings or accumulated profits out of which any dividends are paid. For example, if \$40 million in qualifying foreign taxes are paid on a

given amount of foreign source income and if the pre-credit U.S. tax liability on that income is \$46 million, the taxpayer will pay \$40 million to the foreign country and \$6 million to the United States.

The foreign tax credit provided by the Internal Revenue Code is limited to the amount of the U.S. tax that would be imposed, if no credit were allowed, on the foreign source income as measured by U.S. rules. This is accomplished by the overall limitation on the foreign tax credit, which is calculated by multiplying the taxpayer's tentative U.S. tax on worldwide taxable income, before credits, by a fraction, the numerator of which is foreign source taxable income and the denominator of which is worldwide taxable income, both before credits. Assume, for example, a taxpayer with foreign source taxable income of \$100 million. Ignoring the reduced U.S. corporate tax rates on the first \$100,000 of taxable income, the foreign tax credits allowed are limited to \$46 million because that is the U.S. tax (46 percent) that would be imposed on the \$100 million of foreign income before credits. If foreign taxes were \$60 million, still only \$46 million would be creditable in the taxable year. It is important to understand that if the full \$60 million of foreign tax credits were allowed, \$14 million in foreign taxes would be permitted to offset U.S. taxes on domestic income. The limitation is therefore necessary to prevent foreign taxes from eroding the U.S. tax base on income from domestic sources. If a taxpayer's creditable foreign taxes exceed the foreign tax credit limitation, such as the \$14 million in the above example, the excess foreign taxes may be carried back two years and forward five years.

C. Foreign Source Taxable Income

The operation of the foreign tax credit limitation is, quite clearly, premised on the correct determination of the U.S. taxpayer's foreign source taxable income. If the U.S. tax on domestic income is not to be reduced by the credit, the relative amounts of domestic and foreign source taxable income must be measured properly.

Foreign source taxable income is, of course, measured under U.S. tax rules. The Code provides that foreign source taxable income is determined by deducting from gross income the "expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income." The detailed rules for the allocation and apportionment of R&E, interest, legal and accounting fees, and other expenses to gross income for the purpose of determining taxable income from foreign and domestic sources are left to the regulations. The objective of the Code and the Regulation is to match the expenses to which the Regulation applies, including R&E, with the income generated by or related to the expenditure.

The rationale for allocating R&E expenses is therefore the same as the rationale for allocating the other expenses covered, such as interest. There is no special rule in the foreign source taxable income provisions of the Code for R&E expenses. The allocation of R&E expenses to foreign income, however, may increase the cost of domestic R&E and interfere with the objective of a stronger technical base for the U.S. economy. The allocation of R&E to foreign income also raises difficult technical issues on the specific contribution of domestic R&E to foreign income.

Absent the ERTA moratorium, the Code clearly requires that there be a proper allocation of U.S. R&E expense to foreign source income. The Regulation implements this provision by requiring the allocation of R&E expense on a product line basis. The objective is to avoid allocating R&E expense related to one product to foreign source income earned from sales in a wholly different product category. R&E expense incurred solely to satisfy a safety, health, or other legal requirement of the U.S. government, and which does not generate income outside the United States, can be allocated exclusively to U.S. source income.

Once allocated, the R&E expense is then divided or apportioned by geographic source or activity. For purposes of determining the foreign tax credit limitation, the apportionment is between the domestic and foreign source components of that income class. After allowing for government-mandated R&E, the Regulation allows a taxpayer performing more than 50 percent of its R&E in the United States to "exclusively apportion" 30 percent of its total R&E expense to U.S. source income, or a larger percentage based on the taxpayer's facts and circumstances. While the principal apportionment method in the Regulation divides R&E between income from foreign and domestic sources on the basis of sales, the taxpayer can choose an alternative that permits R&E expense to be apportioned on the basis of relative amounts of gross income from foreign and domestic sources. Under this alternative, however, the apportionment of R&E expense to foreign income must be at least one-half the apportionment made under the sales method. Because the ratio of foreign source gross income to worldwide gross income tends to be much smaller than the ratio of foreign sales to worldwide sales, this means that in most cases the amount of R&E apportioned to foreign income under the sales method can be reduced by a full 50 percent by using the gross income option.

The Regulation's R&E rules are the product of extensive consideration over a ten-year period and reflect taxpayer comments as well as consultations between the Treasury Department, representatives of multinational corporations, and a Task Force of President Ford's Economic Policy Board. The history of the development of the R&E rules is described in greater detail in the second part of my testimony. The R&E rules in the Regulation are an objective attempt to satisfy the statutory requirement that R&E expense be allocated and apportioned between domestic and foreign source income.

On tax policy grounds, some allocation to foreign source income is appropriate when domestic R&E is exploited in a foreign market and generates foreign, as well as domestic, income. Likewise, the allocation of interest and other expenses to foreign source income is compelled by the Code, and by proper tax policy considerations, when an expense item generates, or is related to, foreign source income. If this allocation is not made, foreign source income will be too high, resulting in a higher foreign tax credit limitation that may allow the credit for foreign tax to reduce U.S. taxes on domestic source income.

The allocation of any domestically incurred expense, including R&E expense, to foreign source income will reduce foreign source taxable income and thus reduce the limitation on the foreign tax credit. If the foreign government does not allow the apportioned expense as a deduction, income taxes actually paid to the foreign government will not be reduced. Consequently, the allocation will increase a taxpayer's total tax liability if it is in an excess foreign tax credit position.

In other words, an allocation of domestic R&E to foreign source income does not reduce a U.S. taxpayer's worldwide taxable income, but only how that income is divided between foreign and domestic sources. The allocation reduces foreign source taxable income and increases domestic source taxable income. If the taxpayer can continue to use all its foreign tax credits, the R&E allocation does not change its U.S. tax liability because total worldwide taxable income is unchanged. This would occur if, as is frequently the case, the effective foreign tax rate is substantially below 46 percent. If, on the other hand, the taxpayer is initially in an excess foreign tax credit position, then any increased allocation of R&E to foreign source income will increase U.S. tax liabilities as the limitation on the credit is reduced. The increase in U.S. taxes will be equal to 46 percent of the additional allocation. Similarly, if the R&E allocation reduces the foreign tax credit limitation by enough to move the taxpayer into an excess credit position, U.S. tax liabilities will also be increased.

U.S. corporations can rightfully claim that they are disadvantaged by the refusal of foreign governments to recognize R&E deductions or cost sharing payments for R&E performed outside the country even though related to income produced, and taxed, in the country. The result would be the same, however, if foreign governments permitted a deduction for foreign R&E, but imposed a tax rate far above the U.S. level. In either case, granting U.S. taxpayers credits above those permitted by the credit limitation would allow foreign taxes to offset U.S. tax liabilities on domestic income.

From the foregoing discussion, it should be clear that the ERTA suspension or any rule of law requiring no allocation of R&E expense to foreign source income to which the expense relates should not be viewed as an attempt to correctly measure the source of income, but as a tax incentive to encourage domestic R&E activity.

D. The Effect of the Suspension

The Treasury Department has carefully studied the important issues raised by the allocation of R&E expense; the results of that study are contained in its recent report to the Congressional tax-writing committees.

The Treasury Department's report found that, if the Regulation's R&E rules had been in effect in calendar 1982 instead of being suspended by ERTA, U.S. tax liabilities of U.S. firms would have been \$100 million to \$240 million higher. The Treasury has continued to review this issue since the report was completed in June. The estimate of the revenue cost depends critically on the excess credit position of a relatively small number of large taxpayers. New data on these taxpayers' excess credit positions indicates that the lower end of the range, \$100 million, is our best estimate of the cost of the suspension in calendar 1982. Projecting forward, a two-year extension would cost \$121 million and \$133 million in reduced tax liabilities in calendar 1984 and 1985, respectively.

The appraisal of the ERTA suspension as an R&E incentive may depend on how the benefits are distributed among different taxpayers. All firms are not affected uniformly. As I described earlier, the ERTA suspension only reduces the tax liabilities of those firms in an excess foreign tax credit position. That is, the reduction in U.S. tax liabilities depends primarily on the nature of a firm's foreign operations, not the level of its R&E effort. Based on the analysis in the Treasury's report, firms in an excess credit position earn approximately 20 percent of the worldwide income of U.S. manufacturing corporations. Whether or not a firm is in an excess credit position does not seem to be closely related to the level of its R&E effort.

The information developed for the Treasury report indicates that the Regulation has its most significant effect on large, mature multinationals, as opposed to small, relatively young, high-technology companies. There are a number of reasons for this:

- (i) Foreign sales tend to be a less significant share of total sales in small high-technology companies. Consequently, a smaller proportion of a given amount of R&E expense will be allocated to foreign income.
- (ii) Even if a small high-technology firm establishes a foreign affiliate, it is most likely, at first, to be a distribution company, which would generally not attract an R&E allocation because of being in a different industry category than the parent performing the manufacturing function.
- (iii) Furthermore, even if a relatively small high-technology company has a manufacturing affiliate abroad, it is likely to be reinvesting its income in its foreign operations rather than distributing the income to its parent. As a result, any R&E allocation

would not lead to an increased current U.S. tax liability because no foreign income would be received or foreign tax credit claimed. Small high-technology companies are therefore not likely to be in an excess foreign tax credit position. However, the allocation could have an impact in future years because the current overall foreign loss created by the allocation may reduce credits when the company begins to repatriate foreign income.

The \$100 million to \$240 million in higher 1982 U.S. tax liabilities in the absence of the ERTA provision, estimated in the Treasury report, would have increased the cost of privately-financed U.S. R&E activity by between .27 and .65 percent, or by less than 1.0 percent. Based on reasonable responses of both the overall level and the geographical location of R&E to this range of cost increases, the \$37 billion in 1982 domestic R&E spending would have been \$40 million to \$260 million lower. If we use only the \$100 million cost figure, which is now our best estimate, we obtain a reduction in R&E in 1982 of from \$40 to \$110 million. Most of this reduction represents a net reduction in overall R&E undertaken by U.S. corporations and their foreign affiliates because U.S. R&E has become somewhat more expensive, rather than a transfer of R&E from a domestic to a foreign location.

Any reduction in domestic R&E would reduce employment in the affected industries. However, it is impossible to determine how aggregate U.S. employment would be affected. Because of the offsetting adjustments that may take place in the U.S. economy, it is always difficult to determine the macro-economic consequences of policies which have a highly concentrated effect on a relatively narrow range of firms and industries. For example, the increase in tax revenues because of the expiration of the ERTA suspension will reduce the deficit. Other sectors may be able to expand more rapidly because of the greater availability of highly-skilled workers. The problem of R&E allocations is therefore not primarily one of finding out how best to increase aggregate employment in the short run, but how to design an appropriate set of incentives for R&E to increase productivity and expand employment opportunities in the long run.

E. Summary of Policy Considerations

The Treasury Department recognizes that any reduction in R&E may adversely affect the competitive position of the United States. Because of the importance of R&E to the international competitiveness of the U.S. economy, it is essential that federal policy be designed so that the limited resources available to finance the federal incentives encourage the maximum in R&E and innovative activity. The Treasury Department also recognizes the conflict in tax policy and R&E incentive objectives arising from the R&E allocation issue.

In light of this recognition, the Administration supports a two-year extension of the present suspension of the Regulation's R&E rules. This would provide Congress with an opportunity to further consider the findings of the Treasury Department's report while Congress and the Administration continue to work together in developing a coherent national program of R&E incentives.

II. Technical Discussion of the Regulation

A. The Determination of Foreign Source Taxable Income

Generally, the source of taxable income is determined under Code sections 861 (domestic source income) and 862 (foreign source income) using a two step process. First, the source of gross income is determined. Expenses are then allocated and apportioned to the gross income to determine taxable income by source.

More particularly, Code sections 861(a) and 862(a) prescribe rules for determining the source of specified items of gross income, including dividends, interest, royalties, receipts from sales of purchased property, and compensation for services. If an item of gross income is not described in one of these categories, it is sourced by analogy to the item of income that it most closely resembles. Sections 861(b) and 862(b) provide that taxable income from a U.S. or foreign source, as the case may be, is determined by deducting from gross income from these sources, the expenses, losses, and other deductions properly allocated or apportioned to the gross income. Where an expense, loss, or other deduction cannot be definitely allocated to an item or class of gross income, these "not definitely allocable" deductions are to be ratably apportioned to each item or class of gross income.

Section 863(b) of the Code prescribes different rules for determining the source of taxable income derived from certain activities, such as the sale of property outside the United States which was manufactured by the taxpayer in the United States, which is considered to generate income from sources partly within and partly outside the United States. For these categories of activities the taxable income from the activity is determined first, by allocating and apportioning expenses to gross income derived from the activity. The source of the taxable income from the activity is then determined under a formula which apportions the taxable income between U.S. and foreign sources.

The Regulation, promulgated under section 861(b), applies by cross-reference to interpret section 862(b). Section 862(b) states that the expenses properly apportioned or allocated to certain items of foreign source gross income, and a ratable part of any expenses which cannot definitely be allocated to an item or class of gross income, shall be deducted from foreign source gross income for purposes of determining foreign source taxable

income. The statute has been interpreted to require the allocation and apportionment of all deductions, without exception, between domestic and foreign source income.

The objective of the Regulation is generally to provide rules which will result in the clear reflection of taxable income by source. Special rules are prescribed for R&E expenses as well as certain other categories of expense which may not be directly related to specific income.

B. Problems in Allocating R&E Expense

The allocation of R&E expense to a particular category of income is difficult because many types of production in a variety of locations can benefit from the same R&E project. Identifying the specific contribution of the project to income in any particular segment may be very difficult.

Allocating R&E expense is also a problem because there is a mismatch between the time of the deduction and the time the R&E produces income. The general tax accounting rule is that taxable income is determined on the basis of an annual accounting period and not on a transactional basis. An expense which relates to tangible or intangible property is capitalized and offset against income through allowances for exhaustion of the property or at the time the property is abandoned. An expense which contributes to current income is allowed as a deduction. Thus, in the case of most expenses it is possible to match the expense with income.

The usual tax accounting rules for expenses are not applicable to "research and experimental" expenditures. Under section 174 of the Code taxpayers may elect to (i) deduct certain "research and experimental" expenditures incurred "in connection with" a trade or business currently, or (ii) treat the expenditure as a deferred expense amortizable over a period of not less than 60 months. The current deduction of research and experimental expenditures disassociates the expense from an identifiable asset or income.

C. History of the Regulation

The first regulations under section 861(b) of the Code were proposed in 1956 and adopted in 1957. This version of the Regulation restated the statutory language and provided a single example. The example indicated that "ratable apportionment" of an expense that could not be definitely related to an item or class of income should be based on the relative amounts of the taxpayer's gross income from domestic and foreign sources. Aside from minor technical amendments in 1966 and 1975, the original regulation continued to apply for taxable years beginning before January 1, 1977.

The Regulation was the subject of continued attention and proposed changes between 1957 and 1977. The Treasury published proposed amendments to the Regulation (and to regulations under section 482) in 1966.

The 1966 proposed regulations provided generally that a deduction would be considered definitely related and allocable to a class of income if it was incurred "in whole or in material part as a result of, or incident to, the activities from which [the] gross income is derived." Special rules were provided for interest, capital losses on sales of property, expenses of performing certain services, income taxes and charitable contributions. Special rules were not prescribed for R&E expenses. The 1966 proposed regulations were withdrawn in 1973 and new proposed regulations were published.

The 1973 proposed regulations included separate rules for the allocation and apportionment of R&E expenses. Under the 1973 proposal, R&E expenses were considered definitely related and therefore allocable to the class of gross income to which a property or process gives rise or is "reasonably expected to give rise," where R&E "is intended to create, or is reasonably expected to result in the creation of, specific intangible properties or processes." All other R&E was required to be allocated to all gross income for the taxable year which is "likely to benefit from the R&E." The 1973 proposed regulations thus required an allocation of R&E expense to extremely broad classes of gross income.

The 1973 proposed regulations generally required that R&E expense be apportioned between domestic and foreign source income in the class of income on the basis of relative amounts of sales unless the taxpayer could demonstrate that another method was more reasonable. Apportionment on the basis of sales was a change from the practice of many taxpayers which was either to make no allocation of R&E expense to foreign source income or to ratably apportion R&E expense based on the relative amounts of the taxpayer's total gross income from foreign and domestic sources.

Taxpayers objected that the "reasonable expectations" allocation rule of the 1973 proposed regulations was too vague to apply and that it could give rise to arbitrary audit adjustments. They also argued that the test failed to take account of the fact that domestic R&E is often exploited first in the domestic market and only later in a foreign market. It was pointed out that while foreign subsidiaries of U.S. corporations may benefit from their parent's R&E, they also may conduct their own R&E program in the foreign market. Taxpayers also objected to apportionment on the basis of relative amounts of domestic and foreign sales. It was argued that it was unreasonable for 50 percent of domestic R&E expense allocated to a class of income to be apportioned to foreign income merely because sales from the class were divided equally between domestic and foreign sources.

After extensive modifications to respond to public comments, revised proposed regulations were published, and the 1973 proposals withdrawn, on November 8, 1976. After minor additional changes were made, the Regulation was adopted on January 3, 1977, effective for taxable years beginning after December 31, 1976.

The final Regulation recognized and responded to taxpayer comments on the 1973 proposed regulation by making a number of significant modifications to the R&E rules.

D. The Regulation's R&E Rules

1. Allocation Rules

Allocation to product categories. The Regulation provides that R&E expenditures are definitely related to all income reasonably connected with the relevant broad category (or categories) of products licensed or sold by the taxpayer. R&E expenses are therefore allocable to all items of gross income from the product category (or categories), including income from sales, royalties, and dividends related to a product category or categories. The Regulation prescribes 32 product categories, based on the Standard Industrial Classification (SIC) system. The objective of the SIC code grouping is to match product area research expense with income from the same product area. R&E on chemicals and allied products (SIC code 28), for example, is allocated to income earned from sales of products in that same product grouping. Thus, the Regulation attempts to avoid allocating R&E on chemicals to income from petroleum refining (SIC code 29), unless the R&E is related to products in both categories.

The special allocation rule for R&E expense is intended to provide taxpayers with certainty which normally could not be obtained with respect to R&E expense under the general allocation rule of the Regulation which requires that an allocation be based on a factual relationship between a deduction and class of gross income. It also responded to taxpayer criticisms of the vague standards of the 1973 proposed regulation. The breadth of the product categories takes account of the speculative nature of R&E by assuming that the R&E may provide benefits beyond a specific product line to related product lines within the product category.

The wholesale and retail trade product categories. If a taxpayer's foreign affiliate performs distribution or retailing functions outside the United States, income from the affiliate will be allocated to the wholesale trade or the retail trade product categories. R&E expense allocable to other product categories (e.g. any manufacturing category) therefore will not be allocable to income derived from an affiliate engaged solely in distribution or retailing. The wholesale trade and the retail trade product categories avoid allocation of manufacturing R&E expense to foreign source income of taxpayers that only perform distribution or retailing functions outside the United States. The R&E rules therefore primarily affect taxpayers that manufacture outside the United States or that license technology for use abroad.

Government-mandated R&E. The Regulation provides an exception for government-mandated R&E by allowing qualifying R&E performed in response to a U.S. Food and Drug Administration or

similar government agency requirement and which does not generate income (beyond de minimus amounts) outside the United States to be allocated solely to U.S. source income. While narrowly drawn, the government requirements rule mitigates the strictness of the R&E allocation rule by allocating to domestic income government required R&E that is not otherwise useful in connection with foreign sales.

2. Apportionment Rules

Once R&E expense is allocated to a class of income, it must be divided or apportioned between the domestic and foreign source components of the class of income. The objective of the Regulation is to match an expense, such as R&E, with the income generated by or related to the expense. The Regulation bases apportionment on relative amounts of gross sales; however, a taxpayer is permitted to use an alternative apportionment method based on the taxpayer's relative amounts of total foreign and domestic gross income. The apportionment under the optional gross income method must equal at least 50 percent of the amount apportioned under the sales method.

The rationale for the use of the sales method of apportionment as a starting point is that many taxpayers exploit successful R&E abroad through a license of the technology (or a product or process embodying the R&E). If a gross income to gross income apportionment is used, foreign source royalty income could be matched with domestic source income from manufacturing, resulting in a very small allocation of R&E to foreign source income. The Regulation's apportionment rules attempt to find a middle ground by allowing a gross income apportionment method that indirectly takes sales into account.

Sales method of apportionment. Under the sales apportionment method a taxpayer may make an "exclusive apportionment" of R&E performed in the United States to U.S. source income. If more than one-half of a taxpayer's R&E is performed in the United States, 30 percent of the taxpayer's entire R&E expense can be apportioned to U.S. source income, before allocation of the remainder. This rule recognizes that R&E is often most valuable in the country where it is performed. A taxpayer may increase the fixed percentage if the facts and circumstances relating to limited or delayed application of its R&E to products sold or processes used outside the United States justify such an increase.

The remaining R&E expense is apportioned on the basis of relative amounts of foreign and domestic sales within the relevant product category. The sales in the apportionment formula include the taxpayer's own sales as well as sales of certain unrelated parties, such as licensees, and sales of controlled corporations that benefit from the R&E connected with a product area. To illustrate the sales method, assume that a corporation performs \$100 of R&E in the United States and has sales divided evenly (50-50) between the United States and foreign markets. In this case, \$30 would be "exclusively

apportioned" to the United States and the remaining \$70 in R&E expense would be apportioned equally between domestic and foreign source income, \$35 to each source.

The sales of related and unrelated parties are taken into account in full even if the other entity itself performs R&E in the product category. These "look through" rules do not take account of foreign R&E performed by the other party because (i) the optional gross income method, described below, implicitly recognizes the foreign R&E and (ii) it may be difficult to administer such a rule.

An important exception to the controlled corporation look through rule is the provision that a controlled corporation's sales are not taken into account if the controlled corporation is a party to a bona fide cost sharing agreement with the taxpayer, under the standard set forth in regulation section 1.482-2(d)(4). At the taxpayer level the R&E expense funded by the cost sharing payment is not subject to allocation and apportionment since it is a reimbursed expense.

Gross income method of apportionment. As an alternative to the sales method, a taxpayer may, under certain circumstances, apportion R&E expense on the basis of relative amounts of gross income from foreign and domestic sources. This method applies to all of the gross income of the taxpayer, not gross income on a product category basis. Under this method, the R&E expense apportioned to foreign source income must be at least 50 percent of the amount apportioned under the sales method. Continuing the above example, \$17.50 (50 percent of \$35) could be apportioned to foreign income under the gross income option. This option permits the R&E apportionment to foreign income to be reduced by up to one-half the R&E expense that would be apportioned under the sales method.

Summary. Compared to the 1973 proposed regulation, the net effect of these modifications was to allow substantially less R&E expense to be allocated and apportioned to foreign source income. For example, a taxpayer with \$100 of R&E and equal amounts of domestic and foreign sales would have been required to allocate \$50 of R&E expense to foreign income under the 1973 proposal. Even without considering the government-mandated R&E provision, this same taxpayer, if it was able to take full advantage of the gross income option, could reduce the allocation to foreign source income to \$17.50 under the current Regulation. This is 35 percent of what would have been allocated under the 1973 proposal.

E. Foreign Countries' Expense Allocation Practices, Tax Treaties, and Alternatives for U.S. Taxpayers

While Treasury has not studied the practices followed by foreign countries in allocating expenses to foreign source income, it is understood that most foreign countries do not have detailed rules for allocating expenses to foreign source income.

Without requesting information from other governments or consulting local counsel, we cannot speculate on the extent to which U.S. allocation and apportionment rules are unique. Some foreign countries reportedly will not allow deductions for bona fide cost sharing payments made by U.S. affiliates for R&E or other overhead expenses. Treasury believes that it is inappropriate to deny a deduction for such payments if the amount is an arm's-length charge.

The practices of foreign countries generally are not taken into account in determining U.S. tax liabilities. For instance, whether a foreign tax is considered a creditable income tax (or a tax in lieu thereof) is determined by reference to U.S. standards as set forth in Treasury regulations under section 901 and 903 of the Code. Similarly, the section 904 limitation fraction used to determine the amount of foreign taxes which may be credited (foreign source taxable income over total taxable income) is determined under U.S. tax rules, without regard to the tax rules applied by the country imposing the tax, though the amount of foreign tax paid or accrued will generally be determined under foreign law. Thus, the fact that the United Kingdom allows expenditures for certain property to be expensed in determining the U.K. income tax liability of a U.K. branch of a U.S. corporation would not be taken into account in calculating foreign source taxable income for purposes of the corporation's U.S. pre-credit income tax liability nor its foreign tax credit limitation. Similarly, for purposes of calculating the limitation, it would be irrelevant that the United Kingdom required an expenditure to be capitalized for which a current deduction would be allowed under the Internal Revenue Code.

A U.S. multinational that is in an excess credit position generally has three tax planning solutions available to address the problem of excess foreign taxes. First it may attempt to reduce the source country tax (e.g. by increasing source country deductions, moving its operations or other techniques). This solution is often impractical for a taxpayer with fixed operations. Alternatively, the taxpayer may attempt to utilize the excess credits currently by either (i) structuring transactions to realize foreign source instead of domestic source income or (ii) accelerating the realization of low tax foreign source income for repatriation without additional U.S. tax. Finally, the taxpayer may minimize the allocation of deductions under the Regulation to foreign source income. For instance, a taxpayer may restrict activities of a foreign subsidiary to wholesaling activities. As discussed above, wholesale trade is a separate product category and income from wholesaling will therefore not attract R&E expense related to the products being sold.

III. Reporting Deficiencies and Revenue Estimates

The elaborate procedures used for estimating the revenue cost of the Regulation for the Treasury report and for the tables included with this testimony were necessary because very few

corporations report the amount of R&E allocated and apportioned under the Regulation.

Corporations claiming a foreign tax credit are required to report on Form 1118, Computation of Foreign Tax Credit, the "Ratable Part of Deductions not Definitely Allocable" to foreign source income. The total amount of expenses apportioned to foreign source income is supposed to be reported on the form and a supporting schedule showing a detailed calculation by type of expense is supposed to be attached. Unfortunately, many corporations do not provide the required supporting information with their returns. Large corporations which are audited every year tend to provide a bare minimum of information on their returns and note that the detail will be available upon audit. For example, they may report a total figure for taxable income from foreign sources without indicating specific deductions. As a consequence, in preparing the foreign tax credit supplement to the 1980 corporation Statistics of Income file, IRS found that more than \$3 billion of deductions allocated to foreign source income under the section 861 were not documented. (The amount of the missing deductions was obtained in follow-ups for missing data.) This represented virtually all of the "deductions not definitely allocable" and about 20 percent of all deductions attributable to foreign source income. In addition to failing to report totals for many items, it appears that less than half of the dollar amount of income, deduction, and tax items reported by corporations is supported by country detail.

It is possible that redesigning the Form 1118 to include space for reporting specific amounts allocated under section 861, which would not require legislation, may improve taxpayer reporting. However, legislation requiring corporations claiming a foreign tax credit to supply adequate information with their returns to verify the credit would be more effective. Such legislation could be modeled on Sections 6038 and 6038A of the Code, which list specific information required to be reported with respect to certain foreign corporations and certain foreign-owned corporations and provide penalties for failure to provide the required information.

The revenue estimates in the following tables are based on the methodology described in the Treasury Report.

Attachments

TABLE 1
 Revenue Cost of Extending ERTA Moratorium
 on R&E Allocations
 to Foreign Source Income
 (in millions of dollars)

	1984	1985	1986	1987	1988	1989
a. One-Year Extension						
Change in calendar year liabilities	121					
Change in fiscal year revenues	60	61				
b. Two-Year Extension						
Change in calendar year liabilities	121	133				
Change in fiscal year revenues	60	127	67			
c. Permanent Extension						
Change in calendar year liabilities	121	133	146	160	176	193
Change in fiscal year revenues	60	127	140	153	168	185

TABLE 2

Effect of ERTA Suspension of
861-8 Allocation on 1982 Calendar Year
Tax Liabilities by Industry

(in millions of dollars)

All Industries	100
Manufacturing	70
Food	4
Chemicals	9
Machinery	4
Electrical Equipment	28
Transportation Equipment	15
Rubber	4
Instruments	6
All Other Manufacturing	0
Non-Manufacturing	30

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**The Impact of the Section 861-8 Regulation
on U.S. Research and Development**

Department of the Treasury

June 1983



THE SECRETARY OF THE TREASURY
WASHINGTON

June 14, 1983

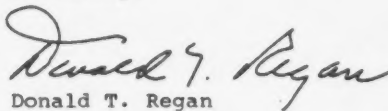
Dear Mr. Chairman:

Section 223 of the Economic Recovery Tax Act of 1981 provides that "the Secretary of the Treasury shall conduct a study with respect to the impact which section 1.861-8 of the Internal Revenue Service Regulations would have (A) on research and experimental activities conducted in the United States and (B) on the availability of the foreign tax credit." Section 223 also provides that "the Secretary of the Treasury shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report on the study together with such recommendations as he may deem advisable."

Pursuant to that section, I hereby submit a report on "The Impact of the Section 861-8 Regulation on U.S. Research and Development."

I am sending a similar letter to Robert Dole, Chairman of the Committee on Finance.

Sincerely,


Donald T. Regan

The Honorable
Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Enclosure



THE SECRETARY OF THE TREASURY
WASHINGTON

June 14, 1983

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Chairman, Committee on Finance
United States Senate
Washington, D.C. 20510

Enclosure

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Chapter 1 - Introduction

Section 223(b) of the Economic Recovery Tax Act of 1981 ^{1/} (ERTA) requires the Secretary of the Treasury to study the impact of Treasury regulation section 1.861-8 ^{2/} (the Regulation) "(A) on research and experimental activities conducted in the United States and (B) on the availability of the foreign tax credit." ^{3/} The required study is related to section 223(a) of ERTA, which provides that, for a two-year period, all research and experimental expenditures which are paid or incurred for research activities conducted in the United States shall be allocated or apportioned to income earned within the United States. Section 223(a) of ERTA, in effect, suspends the section of the Regulation dealing with the allocation and apportionment of research and experimental expenditures between income earned inside and outside the United States.

The suspension and study provisions contained in ERTA reflect the Congressional interest in the Regulation's potential effect on U.S.-based research activities. Under U.S. law, a U.S. corporation is taxable on its worldwide income, whether earned in the United States or in foreign countries. Since income earned outside the United States (foreign source income) typically is also taxed by the country where it is earned, the United States allows income taxes paid to a foreign country to be credited against a taxpayer's U.S. income tax liability, up to an amount equal to the U.S. tax on foreign source income.

The Regulation, issued January 3, 1977, specifies how a U.S. taxpayer's expenses, losses, and other deductions are to be divided between its income from domestic and foreign sources. Special rules are provided for certain kinds of expenses including research and development (R&D), interest, and legal and accounting fees. The suspension of the Regulation applies only to the special rules for R&D. The attribution of R&D expenses to foreign source gross income and consequent reduction in foreign source taxable income may reduce the foreign tax credit allowable under U.S. law. If the foreign government does not allow the apportioned expense as a deduction, income taxes actually paid to the foreign government will not be reduced and,

^{1/} P.L. 97-34.

^{2/} Unless otherwise indicated, all section and regulation references in this report are to the Internal Revenue Code of 1954, as amended, and regulations promulgated thereunder to the date of this report.

^{3/} P.L. 97-34, section 223(b).

therefore, a U.S. taxpayer's total, domestic plus foreign, tax liability will increase, if its foreign taxes paid are in excess of the limitation allowed under U.S. law.

The possibility of increased total taxes and the accompanying effect on U.S.-based R&D activity motivated the enactment of section 223 of ERTA. U.S. multinational businesses contended that the Regulation caused U.S. business to transfer U.S.-based research activity abroad in order to obtain a tax deduction under foreign law and thereby reduce foreign tax liability. ^{4/} The legislative history of section 223 indicates that Congress believed that the transfer of U.S. research activities overseas is not in the best interests of the United States. This concern was the principal reason for the ERTA provisions suspending the Regulation by allowing expenses for U.S. R&D activities to be allocated or apportioned entirely to U.S. income for a two-year period and requiring the Secretary of the Treasury to study the impact of the Regulation on U.S. R&D. ^{5/}

Chapter 2 discusses U.S. taxation of foreign source income, the role of the foreign tax credit and its limitation, the operation of the Regulation, and the potential effect of the Regulation's R&D rules. In the absence of the suspension of the Regulation's R&D rules, the law clearly requires a proper allocation of U.S. R&D to foreign source income. The Regulation's R&D rules reflect significant modifications of the 1973 proposed regulation in response to taxpayer comments. Compared to the 1973 proposed regulation, the Regulation's R&D rules, as modified, allow significantly less R&D expense to be allocated to foreign source income.

A U.S. corporate taxpayer is subject to U.S. tax at a 46 percent rate on income from both domestic and foreign sources. ^{6/} Foreign income taxes are creditable against U.S. tax on foreign source income. Section 904 of the Code effectively limits the foreign tax credit to 46 percent of foreign income. The objective of the limitation is to prevent foreign taxes from reducing U.S. tax on domestic income. The domestic and foreign portions of a taxpayer's worldwide taxable income are, for purposes of the

^{4/} Tax Incentive Act of 1981, H. Rept. No. 97-201, 97th Cong., 1st Sess., 1981, p. 131 and Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, 97th Cong., 1st Sess., p. 142 (hereinafter cited as "ERTA, General Explanation").

^{5/} H. Rept. No. 97-201 and ERTA General Explanation, pp. 141-142.

^{6/} Lower rates apply to the first \$100,000 of taxable income.

limitation on the credit, determined under U.S. law. The Regulation is instrumental in the determination of foreign source taxable income. On the one hand, allocating R&D expense to foreign source income will increase a taxpayer's total, domestic plus foreign, tax liabilities, if it is in an excess foreign tax credit position. On the other hand, not requiring any allocation of R&D expense to foreign income probably overstates foreign source income and may permit foreign taxes to reduce U.S. taxes on domestic income.

Chapter 3 estimates and analyzes the effect of the Regulation's R&D rules on U.S. tax liabilities and U.S.-based R&D activities. If the R&D rules in the Regulation had been in effect in calendar year 1982, instead of the ERTA suspension or moratorium, U.S. tax liabilities of U.S. firms would have been \$100 million to \$240 million higher. Since privately-funded R&D performed in the United States was about \$37 billion in 1982, this estimated increase in U.S. tax liabilities would have increased the cost of domestic R&D between .27 and .65 percent, or by less than 1.0 percent. This cost increase will have two effects: less R&D will be performed and some will be moved from the United States to abroad. Based on assumed responses of both the overall level and the geographical location of R&D to this range of cost increases, domestic R&D spending would have been reduced by about \$40 million to \$260 million in 1982. Most of the reduction is accounted for by the net reduction in the overall level of R&D rather than a transfer abroad.

Chapter 4 contains the report's conclusions and recommendation. All firms are not affected uniformly by the suspension of the Regulation. It only reduces the tax liabilities of firms in an excess foreign tax credit position. These firms earn from 16 percent to 22 percent of the worldwide income of U.S. manufacturing corporations. Whether or not a firm is in an excess credit position does not seem to be closely related to the level of its R&D effort. The suspension of the Regulation has its most significant impact on large, mature multinational firms, as opposed to small, emerging, high technology companies. It affects those R&D oriented taxpayers with relatively large amounts of foreign production and income, as opposed to those taxpayers exploiting their R&D primarily for domestic production. Nonetheless, the Treasury Department recognizes that the reduction in R&D may adversely affect the competitive position of the United States. Accordingly, the Treasury supports a two-year extension of the present moratorium. This will give Congress an opportunity to consider the findings of this report while Congress and the Administration work to develop a coherent national program of R&D incentives.

Chapter 2 - U.S. Taxation of Foreign Source Income

U.S. citizens, residents, and corporations are subject to U.S. tax on their income from all sources, both domestic and foreign. 1/ Since income derived from sources outside the United States (foreign source income) is usually also taxed by the foreign country where it is earned, the United States allows a credit for foreign taxes imposed on foreign source income.

A. Foreign tax credit

The foreign tax credit provides U.S. taxpayers with a dollar for dollar reduction of, or offset against, their U.S. income tax liability. One hundred dollars of allowable credit, for example, reduces U.S. income tax liability by an equivalent amount. Under the foreign tax credit provisions of the Code, a U.S. taxpayer is permitted to credit "income, war profits, and excess profits taxes," or taxes in lieu thereof, paid to a foreign jurisdiction against its U.S. income tax liability. 2/ The credit is available for income taxes paid on foreign branch income, withholding taxes (on such items as dividends from a foreign corporation, interest and royalties) and, provided the U.S. taxpayer is a corporation which owns at least ten percent of the voting stock of the foreign corporation, the corporate tax on the underlying earnings or accumulated profits out of which any dividends are paid. 3/

B. Foreign tax credit limitation

By allowing a foreign tax credit, the United States cedes primary taxing jurisdiction to the source country, i.e., the foreign country in which the income is earned. If \$40 in qualifying foreign taxes are paid on a given amount of foreign source income and if the pre-credit U.S. tax liability on that income is \$50, the taxpayer will pay \$40 to the foreign country and \$10 to the United States. In this situation, the tax collected by the

1/ I.R.C. sections 1, 11, and 61; contrast U.S. source based taxation of nonresident aliens and foreign corporations under I.R.C. sections 871(b) and 882(a).

2/ I.R.C. sections 33, 901, and 903. The foreign tax credit for income, excess profits, and war profits taxes paid was first enacted in 1918. Revenue Act of 1918, sections 222, 238, and 240(c). The credit was expanded to include taxes paid in lieu of income, excess profits and war profits taxes in 1942. Revenue Act of 1942, section 158(f).

3/ I.R.C. sections 33, 901, 902, and 960.

United States is limited to a residual amount after foreign tax. Under U.S. law and long-standing U.S. international tax policy, the foreign tax credit is limited to the U.S. tax on the foreign source income. A U.S. taxpayer pays the higher of the U.S. or foreign rate on foreign source income. In the above example, if foreign taxes were \$60, rather than \$40, the credit would be limited to \$50, the U.S. tax on the foreign source income. The purpose of the limitation is to prevent foreign taxes from reducing U.S. taxes on domestic source income. 4/ Taxes paid to France, for example, can be used to reduce U.S. tax on income earned in France, but not on income earned in the United States.

If a taxpayer's creditable foreign taxes exceed the foreign tax credit limitation, the excess foreign taxes may be carried back two years and forward five years. 5/ If a taxpayer elects to credit foreign taxes in any taxable year, all creditable foreign taxes must be credited and none may be deducted. Non-creditable foreign taxes may be deducted. 6/ In addition, a taxpayer may choose, for any taxable year, to deduct otherwise creditable foreign taxes. 7/

Section 904 of the Code limits the foreign tax credit to the amount of U.S. tax which would be payable, absent the foreign tax credit, on the foreign source taxable income of the U.S.

4/ The foreign tax credit enacted in 1918 did not include a limitation. Thus, foreign income taxes could be credited against U.S. tax liability even when the effective foreign tax rate exceeded the effective U.S. tax rate, with the result that U.S. taxes on U.S. source income would be offset. In effect, this meant the U.S. would forego taxes to the extent taxes were paid to a foreign taxing jurisdiction. The foreign tax credit limitation was first adopted in the Revenue Act of 1921, three years after the foreign tax credit was enacted. Revenue Act of 1921, ch. 136, section 222(a)(5) (limitation for individuals), section 238(a) (limitation for corporations), 42 Stat. 227, 249, 258; H. Rep. No. 350, 67th Cong., 1st Sess. 13 (1921).

5/ I.R.C. section 904(c). The provision for the carryback and carryover of excess foreign taxes was added in 1958 by section 42 of the Technical Amendments Act of 1958. It significantly mitigates the effect of the foreign tax credit limitation.

6/ I.R.C. section 164(a).

7/ I.R.C. section 164(a) and 904(c).

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taxpayer. The limitation is calculated by multiplying the taxpayer's tentative U.S. tax on worldwide income (the U.S. tax before reduction by the foreign tax credit) by a fraction, the numerator of which is the taxpayer's foreign source taxable income and the denominator of which is the taxpayer's worldwide taxable income. This may be expressed as follows:

$$\text{Maximum allowable foreign tax credit} = \frac{\text{Tentative U.S. tax on worldwide taxable income}}{\text{Worldwide taxable income}} \times \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}}$$

In a simple example, assume that a corporate taxpayer has foreign source taxable income of \$400, worldwide taxable income from domestic (\$600) and foreign (\$400) sources of \$1,000, and tentative U.S. tax of \$460 (46 percent of \$1,000). Under these circumstances, the foreign tax credit would be limited to:

$$\$460 \times \frac{\$400}{\$1,000} \text{ or } \$184.$$

The formula used to calculate the credit may be modified by transposing the terms to equal:

$$\frac{\text{Maximum allowable foreign tax credit}}{\text{Foreign source taxable income}} = \frac{\text{Tentative U.S. tax on worldwide taxable income}}{\text{Worldwide taxable income}} \times \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}}$$

Since the reduced U.S. corporate rates for U.S. taxpayers with \$100,000 or less of taxable income are probably not significant for most multinational corporations, the limitation can be thought of as:

$$46 \text{ percent} \times \text{Foreign source taxable income}$$

Thus, the allowable foreign tax credit is the lesser of the U.S. or foreign taxes on foreign source taxable income.

C. Foreign source taxable income

Recasting the limitation formula in this way demonstrates that the foreign tax credit limitation is directly related to the amount of foreign source taxable income. If the U.S. tax on domestic income is to be unaffected by the credit, the relative amounts of domestic and foreign source taxable income must be measured properly.

This measurement is made under U.S. tax rules. Sections 861 and 862 of the Code prescribe rules for determining the source of specified items of gross income, including dividends, interest,

royalties, receipts from sales of purchased property, and compensation for services. These sections also provide that taxable income from a U.S. or foreign source is determined by deducting from gross income from these sources, the expenses, losses, and other deductions properly allocated or apportioned to the gross income. Where an expense, loss, or other deduction cannot be definitely allocated to an item or class of gross income, sections 861(b) and 862(b) each provide that these "not definitely allocable" deductions are to be ratably apportioned to each item or class of gross income. Thus, these Code sections are critical to determining foreign source taxable income. Section 863(b) of the Code prescribes slightly different rules for gross income derived from sources partly within and partly without the United States, such as the sale of property outside the United States which was manufactured by the taxpayer in the United States.

D. Regulation section 1.861-8

1. The scope of the Regulation. Regulation section 1.861-8 prescribes rules for the allocation and apportionment of expenses to items and classes of gross income for purposes of determining taxable income from a source or activity. It specifies the deductions from items of gross income from sources within the United States for purposes of determining U.S. source taxable income under Code section 861(b). The rules also apply by cross-reference to sections 862(b) and 863(b) for the purpose of determining taxable income from specific sources. ^{8/} Section 862(b) of the Code requires the allocation and apportionment of expenses to foreign source gross income for purposes of determining foreign source taxable income. While the Regulation applies to a broad spectrum of expenses, paragraph (e)(3) sets forth rules for the allocation and apportionment of R&D expenses.

2. Background of the R&D rules. The Regulation was subject to a long period of review and substantial revision before it was published January 3, 1977. These revisions were responsive to taxpayer comments on the 1973 proposed version of the Regulation.

^{8/} The same rules are also applied by cross-reference to determine taxable income from specific activities under other so-called "operative" sections of the Code as well. The operative sections to which the allocation and apportionment rules apply are listed at Regulation section 1.861-8(f)(1). The section 904 limitation on the foreign tax credit allowed to a taxpayer for a taxable year is generally regarded as the most significant "operative" section to which the regulation applies.

According to taxpayers, the 1973 proposed regulation required the allocation of too much R&D to foreign income because it did not take account of a number of important issues.

Taxpayers commented that while U.S. R&D may benefit a broad category of products, not all of these products are necessarily sold in a foreign market. Domestic R&D is often exploited first in the domestic market, and only later in a foreign market. Although foreign subsidiaries of U.S. corporations may benefit from the parent's R&D, they also may have their own R&D program in the foreign market. According to taxpayers, these factors meant that U.S. R&D was more valuable in the domestic than in a foreign market. Based on this reasoning, the 1973 proposed regulation apportioned too much expense to foreign source income. That apportionment was made on the basis of relative amounts of domestic and foreign sales. Taxpayers felt it unreasonable for 50 percent of domestic R&D expense to be allocated to foreign income merely because gross sales were divided equally between domestic and foreign sources.

The current Regulation recognized and responded to these concerns by making a number of significant modifications to the proposed 1973 regulation.

(a) R&D expense incurred solely to satisfy a safety, health, or other legal requirement of the U.S. government, and which does not generate income outside the United States, can be allocated to U.S. source income.

(b) The Regulation allocates R&D on a product line basis. The objective is to avoid allocating R&D expense related to one product to foreign source income earned from sales in a wholly different product category.

(c) After allowing for government-mandated R&D, the Regulation allows a taxpayer performing more than 50 percent of its R&D in the United States to "exclusively apportion" 30 percent of its total R&D expense to U.S. source income, or a larger percentage based on the taxpayer's facts and circumstances.

(d) While the principal apportionment method in the Regulation divides R&D between foreign and domestic sources on the basis of sales, an optional gross income alternative permits the R&D apportioned to foreign source income to be reduced by up to one-half the sales-based apportionment amount.

Compared to the 1973 proposed regulation, the net effect of these modifications is to allow substantially less R&D expense to be allocated and apportioned to foreign source income. For example, a taxpayer with \$100 of R&D and equal amounts of domestic and foreign sales would have been required to allocate \$50 of R&D

expense to foreign income under the 1973 proposal. Even without considering the government-mandated R&D provision, this same taxpayer, if it was able to take full advantage of the gross income option, could reduce the allocation to foreign source income to \$17.50 under the current Regulation. This is 35 percent of what would have been allocated under the 1973 proposal.

The Regulation can be viewed as an objective attempt to satisfy the statutory requirement that R&D be allocated and apportioned to its domestic and foreign source income. It allows a relatively large share of a taxpayer's R&D expense to be allocated to domestic income. When domestic R&D is exploited in a foreign market and generates foreign, as well as domestic income, some allocation to foreign source income is appropriate on tax policy grounds.

3. The Regulation's R&D rules. This section summarizes the rules for the allocation and apportionment of R&D expense set forth in paragraph (e)(3) of the Regulation. The basic thrust of the rules is to require the allocation of R&D expense to a class of income to which the expense is related. Once allocated, the expense is then divided or apportioned by geographic source or activity. For purposes of determining the foreign tax credit limitation, the apportionment is between the domestic and foreign source components of that income class.

a. Allocation rules. The Regulation provides that R&D expenditures are definitely related to all income reasonably connected with the relevant broad category (or categories) of products licensed or sold by the taxpayer. R&D expenses are therefore allocable to all items of gross income as a class, including income from sales, royalties, and dividends related to a product category or categories. The Regulation prescribes 32 product categories, based on the Standard Industrial Classification (SIC) system. The objective of the SIC code grouping is to match product area research expense with income from the same product area. R&D on chemicals and allied products (SIC code 28), for example, is allocated to income earned from sales of products in that same product grouping. Thus, the Regulation attempts to avoid allocating R&D on chemicals to income from petroleum refining (SIC code 29), unless the R&D is related to products in both categories. The Regulation provides an exception for government-mandated R&D by allowing qualifying R&D performed in response to a U.S. Food and Drug Administration or similar government agency requirement and which does not generate income outside the United States to be allocated solely to U.S. source income.

b. Apportionment rules. Once R&D expense is allocated to a class of income, it must be divided or apportioned between the domestic and foreign source components of the class of

income. The objective of the Regulation is to match an expense, such as R&D, with the income generated by or related to the expense. The Regulation allows the apportionment to be made either on the basis of relative amounts of sales or gross income.

(i) Sales method of apportionment. The initial step in the sales apportionment method permits a taxpayer to make an "exclusive apportionment" of R&D performed in the United States to U.S. source income. Under this provision, if more than one-half of a taxpayer's R&D is performed in the United States, 30 percent of the taxpayer's entire R&D expense can be apportioned to U.S. source income, before allocation of the remainder. This rule recognizes that R&D is often most valuable in the country where it is performed. The remaining R&D expense is apportioned on the basis of relative amounts of foreign and domestic sales within the relevant product category. The sales in the apportionment formula include the taxpayer's own sales as well as sales of certain unrelated parties, such as licensees, and sales of controlled corporations that benefit from the R&D connected with a product area. To illustrate the sales method, assume that a corporation performs \$100 of R&D in the United States and has its sales divided evenly (50-50) between the United States and foreign markets. In this case, \$30 would be "exclusively apportioned" to the United States and the remaining \$70 in R&D expense would be apportioned equally between domestic and foreign source income, \$35 to each source.

(ii) Gross income method of apportionment. As an alternative to the sales method, a taxpayer may, under certain circumstances, apportion R&D expense on the basis of relative amounts of gross income from foreign and domestic sources. This method applies to all of the gross income of the taxpayer, not gross income on a product category basis. Gross income from domestic sources typically includes gross receipts less cost of goods sold while gross income from foreign sources generally consists of income received by the taxpayer from affiliates or licenses, such as dividends, interest, and royalty payments. Under this method, the R&D expense apportioned to foreign source income must be at least 50 percent of the amount apportioned under the sales method. Continuing the above example, \$17.50 (50 percent of \$35) could be apportioned to foreign income under the gross income option. This option permits the R&D apportionment to foreign income to be reduced by up to one-half the R&D expense that would be apportioned under the sales method.

4. Potential effects of the Regulation. The objective of the R&D expense allocation and apportionment required by the Code and interpreted by the Regulation is to accurately measure relative amounts of domestic and foreign source taxable income. As explained earlier in this chapter, the foreign tax credit limitation is directly related to the calculation of foreign source

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taxable income. In order for the foreign tax credit limitation to prevent the credit for foreign taxes from offsetting U.S. tax on domestic source taxable income, foreign source taxable income must be accurately determined.

(a) Effect on foreign tax credit limitation. For a large U.S. corporate taxpayer, recall that the limitation can be thought of as equal to:

$$46 \text{ percent} \times \text{Foreign source taxable income}$$

Any allocation of R&D expense to foreign source income will reduce taxable income and the limitation on the credit.

This can be illustrated by recalling the earlier example.

$$\begin{aligned} \text{Foreign tax credit limit} &= 46 \text{ percent} \times \text{Foreign source taxable income} \\ &= 46 \text{ percent} \times \$400 = \$184 \end{aligned}$$

While no R&D was initially allocated to foreign income, suppose, for purposes of illustration, that \$10 of R&D expense is properly allocable to foreign income. The limitation is now equal to:

$$46 \text{ percent} \times \$390 = \$179.40$$

Because of the R&D expense allocation, the limitation has been reduced by \$4.60, or 46 percent of \$10.00.

(b) Effect on tax liabilities. The U.S. taxpayer's foreign tax liability would be unchanged by the allocation of R&D expense if the foreign country where the income is earned (the source country) does not explicitly recognize the apportioned R&D as a legitimate deduction for its own tax purposes. The United States and the foreign country, that is, may have different rules to determine how income earned in the foreign country should be measured. ^{9/} Since foreign taxes are unchanged, but the limitation is reduced, it is possible for the R&D allocation to increase a taxpayer's overall, U.S. plus foreign, tax liability.

In the above example, assume that foreign taxes on the \$400 of foreign source taxable income also equal \$184 (46 percent of \$400). If no R&D expense is allocated to foreign income, the foreign tax credit fully eliminates the U.S. tax on foreign source taxable income. The United States, however, collects \$276

^{9/} This problem is not unique to R&D expense. It also occurs, for instance, with respect to different rules for depreciation and depletion.

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(46 percent of \$600) in tax on domestic source taxable income. The taxpayer's total liability is \$460 (\$184 foreign and \$276 U.S.).

<u>Before Allocation</u>	<u>Foreign tax</u>	<u>Foreign tax credit</u>	<u>U.S. tax</u>
Foreign source taxable income (\$400)	\$184	\$184	--
Domestic source taxable income (\$600)	--	--	\$276
Total	<u>\$184</u>		<u>\$276</u>

Total tax: \$184 + \$276 = \$460

Once the \$10.00 in properly allocable R&D expense is allocated to foreign income, domestic source taxable income, as determined by U.S. standards, increases and foreign source taxable income decreases. U.S. tax on domestic source taxable income increases by \$4.60, 46 percent of the \$10.00 increase in domestic income. If foreign taxes are not reduced, total tax liability increases by \$4.60, to \$464.60. The \$4.60 excess foreign tax may be carried back two years and carried forward five years as a foreign tax credit.

<u>After Allocation</u>	<u>Foreign tax</u>	<u>Foreign tax credit</u>	<u>U.S. tax</u>
Foreign source taxable income (\$390)	\$184	179.40	--
Domestic source taxable income (\$610)	--	--	280.60
Total	<u>\$184</u>		<u>280.60</u>

Total tax: \$184 + \$280.60 = \$464.60

The example involves only a single foreign country with a high tax rate. Since the United States generally uses an "overall" foreign tax credit limitation, taxable income from countries with low effective tax rates may be combined with taxable income from countries with high effective tax rates. Thus, income taxes from countries with higher effective tax rates than the United States may in certain circumstances be allowed as a foreign tax credit in the year paid.

If the amount of taxes actually paid to the foreign government is below the foreign tax credit limitation, the allocation of expense will not affect overall tax liabilities. If, in the

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above example, actual foreign taxes paid are \$175, rather than \$184, the allocation of R&D expense to foreign income does not increase total taxes. In this case, either with or without the allocation of R&D expense, the taxpayer pays \$175 in taxes to the foreign country and \$285 to the United States for a total liability of \$460.

(c) Effect on U.S. tax revenues. The fact that the Regulation may affect overall tax liabilities illustrates its role in limiting the foreign tax credit to taxes on foreign source income and thereby preventing foreign income taxes from reducing U.S. taxes on domestic income. The allocation of R&D expense required by the Regulation changes the mix of domestic and foreign source taxable income, but does not affect worldwide taxable income as determined by U.S. tax law. In the example, the allocation of \$10 in R&D expense reduces foreign source taxable income by \$10 and increases domestic source taxable income by a like amount. In other words, the objective of the Regulation is to divide the pool of worldwide taxable income into its respective domestic and foreign components. If the appropriate allocation of R&D expense to foreign income is not made, foreign source taxable income is too high, domestic source taxable income too low. This can be seen by comparing, before and after the allocation, the relative amounts of domestic and foreign taxable income in the example.

	<u>Domestic source taxable income</u>	<u>Foreign source taxable income</u>	<u>Worldwide taxable income</u>
Before expense allocation	\$600	\$400	\$1,000
After expense allocation	\$610	\$390	\$1,000

In this example, requiring no allocation of R&D expense to foreign income overstates foreign source taxable income and the limitation on the foreign tax credit. In this instance, allowing a foreign tax credit of \$184 (46 percent of \$400) allows foreign taxes to eliminate U.S. tax on the full \$390 in foreign source income, plus \$10 in domestic source income. Thus, requiring no allocation of expense to foreign income allows the foreign tax credit to reduce U.S. taxes on domestic source income. In this example, allowing foreign taxes to offset U.S. tax on \$10 in domestic income reduces U.S. tax revenues by \$4.60.

Chapter 3 - Economic Analysis

The economic impact of the Regulation depends on the extent to which total tax liabilities to foreign countries and the United States increase. Since tax liabilities to a foreign country are generally not affected by the Regulation, any increase in overall tax liabilities is the result of higher U.S. taxes. If the allocation of R&D expense to foreign income increases U.S. tax liabilities, both the amount and the location of R&D may be affected. This chapter assesses these possibilities.

A. The effect of the R&D rules on U.S. tax liabilities

If the R&D rules in the Regulation had been in effect in calendar year 1982 instead of the ERTA suspension, U.S. tax liabilities of U.S. firms would have been \$100 million to \$240 million dollars higher. ^{1/} The estimate is presented as a range, rather than a single dollar figure, because of the lack of precise information on firms' actual R&D allocations to foreign income. Firms generally do not report R&D expense allocated to foreign income as a separate and identifiable item on Form 1118, "Computation of Foreign Tax Credit for Corporations." This is the form on which foreign taxes paid are reported and the foreign tax credit limitation is calculated. Instead, taxpayers report only the total of the "Ratable Part of Deductions Not Definitely Allocable" on the Form 1118 without specifying the breakdown of these deductions among R&D, interest, general and administrative, stewardship, and so forth.

1. Preliminary estimate. Because of the absence of direct comprehensive information on R&D allocations by firms, information from a variety of sources was used in the following sequential process to arrive at a cost estimate.

a. Excess foreign tax credit positions. The first step in the estimation procedure was to determine whether U.S. companies were in an excess foreign tax credit position. That is,

^{1/} This estimate does not include any increase in U.S. tax liabilities due to R&D allocation to income eligible for a credit under section 936 of the Code. Changes made in that section by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) specify the R&D allocations to be made in determining income eligible for the 936 credit without reference to Regulation 1.861-8. Therefore, after the August 14, 1982 effective date of the TEFRA provisions, any suspension of the Regulation would not affect the determination of income eligible for the 936 credit.

whether they had paid foreign taxes in excess of the foreign tax credit limitation. This determination was made by using the most recent Form 1118 computer file, for taxable years ending between July 1, 1978 and June 30, 1979 (referred to as the 1978 Statistics of Income (SOI) sample). The computer file contains information on all firms in the SOI foreign tax credit sample and covers more than 99 percent of the total foreign tax credits claimed by corporations.

From the 1118 computer file, it was possible to determine whether each firm would have been in an excess credit position if the U.S. corporate rate applicable for calculating the foreign tax credit limitation had been 46 percent. ^{2/} The determination of excess credit positions reflects taxpayers' allocations of R&D and other expenses to foreign income. The information in the 1978 SOI sample is based on tax returns before any audit adjustments by the Internal Revenue Service (IRS). Because of the possibility that audit adjustments could have a substantial effect on companies' foreign tax credit positions, audit information was obtained from the IRS.

b. Adjustment for IRS audits. In order to determine the impact of audit adjustments on excess foreign tax credit positions of U.S. firms, the IRS was asked to provide information on the last completed audit for 96 major firms in the foreign tax credit sample. This information revealed the impact of audits on foreign source taxable income and on foreign tax credits. Excess credit positions would increase, for example, if audit adjustments increased the foreign taxes allowed as credits or reduced foreign source taxable income.

For the 96 firms as a whole, the audit adjustments reduced foreign tax credits (before allowing for the limitation) by about 8.0 percent and reduced foreign source taxable income by only 0.15 percent. Based on these overall estimates, IRS audit adjustments tended to reduce excess foreign tax credit positions. The 96 firms in the audit sample were classified by industry and the average percentage change in foreign tax credits and foreign source taxable income was computed for each industry category. These industry percentage changes due to audits were then applied to the pre-audit credit and income information in the comprehensive 1118 computer file.

c. Industry foreign tax credit position. After being adjusted for audit changes, the returns in the 1118 computer file were used to estimate an average excess foreign tax credit position by industry. The average excess credit position for each

^{2/} The maximum corporate rate changed from 48 percent to 46 percent for taxable years beginning after 1978.

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industry was computed by assigning a value of 1 to each firm in the industry in an excess credit position, a value of zero to a firm not in an excess credit position, and using each firm's worldwide taxable income as weights. Worldwide taxable income was used because, of all the information on the 1118 file, it was likely, within an industry, to be most closely related to the volume of R&D expenses. ^{3/} The following calculation illustrates the method used.

Calculation of Industry Excess Credit Position

Firm	Excess Credit Position	Value	Worldwide Taxable Income
A	Yes	(1)	\$100,000
B	No	(0)	200,000
C	No	(0)	400,000
D	Yes	(1)	300,000

Average industry excess credit position =

$$\frac{100,000 + 300,000}{100,000 + 200,000 + 400,000 + 300,000} = 40 \text{ percent}$$

The excess credit index, 40 percent in this example, indicates the share of the industry's R&D allocated to foreign source income which causes an increase in U.S. tax liabilities because of credit limitations. Since the determination of whether a firm was in an excess credit position was made after the allocation of R&D expense, the industry indices tend to be maximum or upper-bound estimates. The estimates assume that excess credit firms were already in that position before the R&D allocation. That is, the 40 percent index in the above example, should be somewhat lower if firms A and D were not in an excess credit position before the R&D allocation was made.

In computing the audit-adjusted excess credit index for each industry a few major firms with large research budgets were very close to the excess credit threshold. Because it is impossible

^{3/} Average industry foreign tax credit positions were based on the "all other income" limitation category, which is the income left over after placing income in the specific limitation categories such as DISC income, special interest, oil related income, and possession income.

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to predict a given firm's post-audit position in any particular future year with certainty, two industry excess credit positions were calculated for industries containing these firms. One was based on the assumption that the firms near the threshold were all in an excess credit position, and the other on the assumption that none were. This accounts for the range of cost estimates presented at the beginning of this chapter.

d. Allocation of R&D expense to foreign income. Industry information on R&D spending and domestic and foreign sales in the U.S. Commerce Department benchmark survey, U.S. Direct Investment Abroad, 1977 was used to calculate an allocation of R&D expense to foreign income. ^{4/} The Commerce survey reports, by industry, the R&D expenditures financed by U.S. parent firms for their own benefit. These expenditures are very close to the total of privately funded industrial R&D in the United States reported by the National Science Foundation. ^{5/} The 1977 R&D data was projected to 1982 on the basis of the growth of total industry financed R&D. The Commerce benchmark survey also reports sales by parents and by their foreign affiliates, both branches and subsidiaries, on an industry basis. ^{6/}

This information on industry R&D and domestic and foreign sales was used to make preliminary estimates of R&D allocations to foreign income by industry. The preliminary estimates were based on the assumption of a 30 percent exclusive apportionment to domestic income. Furthermore, it was assumed that parent and foreign affiliate sales were in the same industry and that the U.S. taxpayer was able to fully utilize the 50 percent gross income option, which permits the allocation of R&D to foreign income by the sales method to be reduced by as much as 50 percent. ^{7/}

^{4/} U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad, 1977, Washington, 1971.

^{5/} See footnote at bottom of Table 1 for more details. The definitions of R&D in both the Commerce and NSF surveys are generally consistent with the R&D definition relevant for section 1.861-8 allocations.

^{6/} The industry list in the Commerce survey is slightly more detailed than the 2-digit classification used in the SIC system. For example, there are 32 industries in manufactures compared to 20 in the 2-digit SIC classification. In the Commerce data, all of the parent's sales are classified in its primary industry.

^{7/} It was also assumed that the ERTA suspension does not reduce the R&D allocations to DISC income.

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e. Increase in U.S. tax liabilities. The preliminary estimate of increased U.S. tax liabilities was calculated by multiplying the industry R&D allocations by the industry indices of average excess foreign tax credit positions and by a corporate tax rate of 46 percent. Assume, for example, that the average excess foreign tax credit position for an industry was 40 percent and that \$10 of R&D expense was allocated to foreign income. In this case, the preliminary estimate of increased U.S. tax liability due to the R&D allocation would equal:

$$.40 \times \$10 \times .46 = \$1.84$$

2. Adjustments to preliminary estimate. Two adjustments to the preliminary estimate were made with the objective of refining the estimated impact of R&D allocations on U.S. tax liabilities.

a. Cost-sharing payments. A taxpayer's R&D expense is not allocated to income from a controlled corporation with which the taxpayer has a bonafide cost-sharing agreement in accordance with the provisions of section 1.482-2(d)(4). This exclusion is based on the view that the income from the controlled affiliate has already borne R&D expense through the cost-sharing payment pursuant to the agreement. To allow for this exception, the preliminary allocation of R&D expense to foreign income was reduced by the amount of cost-sharing payments. The information on cost-sharing payments was derived from the benchmark survey, which reports parent's assessments on affiliates for R&D expenses. These assessments, or foreign affiliate share of cost-sharing, totalled \$227 million in 1977. ^{8/}

b. Comparison with actual R&D allocations. An important refinement of the preliminary estimate of R&D allocations to foreign income was based on a sample of 24 firms who specifically reported their R&D allocation to foreign income on the Form 1118. These 24 firms were mainly large public companies with substantial R&D expenditures. For these 24 firms it was therefore possible, from the 10-K report filed with the Securities and Exchange Commission (SEC), to obtain information on their R&D expenses and their sales, both foreign and domestic. By using this information it was possible to replicate what the R&D allocation for each of these 24 firms would have been if the simplified procedure used in the preliminary estimate had been followed. These hypothetical R&D allocations were then compared with the actual allocations made on their tax returns.

^{8/} U.S. Department of Commerce, U.S. Direct Investment Abroad, Table I.29, p. 103. The adjustment made for cost sharing payments assumes that cost sharing payments replace an equal dollar amount of section 1.861-8 R&D allocations.

This comparative analysis revealed that most taxpayers (19 of 24 cases involving more than 95 percent of the R&D in the sample) allocated less than they would have under the preliminary procedures. The preliminary estimate was therefore scaled down by the percentage difference between the actual and hypothetical allocations. It is not surprising that actual allocations were substantially less than the hypothetical allocations in the preliminary estimate. There are several opportunities in the Regulation for reducing the R&D allocation that could not be explicitly allowed for in the preliminary estimate. For example, sales by a distribution affiliate abroad generally do not attract an R&D allocation because they are in a different 2-digit SIC category than the sales of the manufacturing parent. Moreover, the U.S. parent does not have to allocate any R&D to foreign income that is undertaken solely to meet U.S. government legal requirements, such as for safety testing not applicable to foreign markets.

3. Other issues. While they did not directly affect the range of cost estimates, the following issues were also considered in analyzing the impact of the Regulation on U.S. tax liabilities.

a. R&D intensive firms. Multiplying the average foreign tax credit position in an industry by the industry R&D allocations might result in systematic errors if R&D intensive firms, those with above average R&D as a percentage of sales, are more (or less) likely to be in an excess foreign tax credit position. To check on this possibility, R&D and sales data were examined for 417 public companies on the Standard and Poor Compustat file that could be matched with those on the Form 1118 computer file. The 417 companies were grouped by industry, and, within each industry, firms in excess foreign tax credit position were put in one group and the remainder in another. It was therefore possible to see whether individual firms within an industry with a relatively high ratio of R&D to sales were more likely to be in an excess credit position. In those industries with a substantial volume of R&D including, computers, drugs, industrial chemicals, aircraft, electronic components, and motor vehicles, firms in an excess credit position had R&D equal to 3.14 percent of sales, while the comparable percentage for firms not in an excess credit position was 3.29 percent. Because the percentages are similar, no adjustments for this factor were necessary.

b. Excess credit threshold. The above discussion and analysis assumes that firms' R&D allocations did not move them into an excess credit position. That is, it assumes that excess credit taxpayers were already in an excess credit position before the R&D allocation. Thus, for those taxpayers, the entire R&D allocation to foreign income increased U.S. tax liabilities. If, instead, the R&D allocation moved some taxpayers into an excess

credit position, the preliminary cost estimate is overstated because not all of the R&D allocation would have increased tax liabilities. ^{9/}

An R&D allocation will move a taxpayer into an excess credit position only if it causes the effective foreign tax rate (foreign taxes as a percent of taxable income) to be higher than 46 percent. Since the average R&D allocation is a relatively modest percentage of foreign source taxable income, it seems unlikely that an R&D allocation itself would cause firms to pass the credit threshold. The average R&D allocation used in the cost estimates, after the adjustments described above, amounted to 1.14 percent of foreign source taxable income. For two major R&D industries, computers and aircraft, the allocations were as high as 3 percent. Thus, an effective foreign tax rate of, say, 44 percent before the R&D allocation would become 45.4 after the R&D allocation, still not enough to create an excess credit position.

c. Future effects. The extent to which the effective tax rate on foreign source taxable income is close to 46 percent, as well as the size of R&D allocations to foreign income, is also useful in judging whether R&D allocations may be more burdensome in the future. While some firms may move over the excess credit threshold, the expected overall increased future burden does not appear large. For example, in industrial chemicals and pharmaceuticals, only about 1 percent of all foreign source taxable income has an effective foreign tax rate of between 44 and 46 percent. (There is substantially more between 40 and 44 percent, so that a significant increase in foreign rates could have an effect.) In office equipment, a substantial amount of foreign income is close to an effective foreign tax rate of 46 percent. In each of two other significant R&D industries, aircraft and scientific instruments, about 20 percent of the foreign source taxable income is in the 44 to 46 percent range. In these three industries, R&D allocations to foreign income may become substantially more burdensome in the future. Still, the possibility that firms in these industries may move over the threshold has already contributed to the upper part of the range of cost estimates.

^{9/} It is true that most of the firms on the 1978 computer file were able to use a 40 percent, rather than the final 30 percent, exclusive apportionment rate. A 30 percent rate may have pushed a few firms into excess credit position, but as indicated in the following discussion in the text, this effect is likely to very small.

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d. Differential firm impact. All firms are not affected uniformly by the Regulation. The information developed for the cost estimate indicates that the Regulation has its most significant effect on large, mature multinationals, as opposed to small, relatively young, high-technology companies. There are a number of reasons for this.

(i) Foreign sales tend to be a less significant share of total sales in small high-technology companies. Consequently, a smaller proportion of a given amount of R&D expense will be allocated to foreign income.

(ii) Even if a small high-technology firm establishes a foreign affiliate, it is most likely, at first, to be a distribution company, which would generally not attract an R&D allocation because of being in a different SIC category than the parent performing the manufacturing function.

(iii) Furthermore, even if a relatively small high-technology company has a manufacturing affiliate abroad, it is likely to be reinvesting its income in its foreign operations rather than distributing it to its parent. As a result, any R&D allocation would not lead to an increased current U.S. tax liability because no foreign income would be received or foreign tax credit claimed.

Another source of differential impact is that only a minority of those U.S. parent corporations receiving income from their foreign affiliates are in an excess credit position. For example, only 23 percent to 32 percent of the worldwide income of all U.S. manufacturing corporations claiming a foreign tax credit is earned by corporations in an excess credit position. For all U.S. manufacturing corporations, 16 percent to 22 percent of worldwide income is earned by firms in an excess credit position.

The data used to estimate the cost of the Regulation appear to support this picture of differential impact among firms. Of the \$100 million to \$240 million estimated increase in additional U.S. tax liabilities, about 85 percent is estimated to be accounted for by 24 U.S. firms on the 1982 list of the 100 largest U.S. industrial corporations compiled by Fortune magazine.

B. Effect of R&D allocations on U.S. R&D

If the Regulation's R&D rules had been in effect in 1982, instead of the ERTA moratorium, the U.S. tax liabilities of U.S. firms would have been \$100 million to \$240 million higher. Since privately-funded R&D performed in the United States was about \$37 billion in 1982, the estimated increase in U.S. tax liabilities represents an increase in the cost of privately-financed U.S. R&D of between .27 and .65 percent, or less than 1.0 percent. This section evaluates the effect of this cost increase on U.S. R&D.

This cost increase will have two separate, but related, effects on domestic R&D. First, it will increase the cost of R&D relative to other investments and non-R&D inputs. Thus, it will tend to reduce domestic R&D spending, even if a shift of R&D to foreign locations is impossible. Domestic R&D would tend to decrease because R&D in general has become more expensive. Secondly, the increase in the marginal cost of domestic R&D represents an increase in the cost of domestically performed R&D relative to the cost of R&D performed abroad. This might reduce the domestic share of the overall R&D performed by U.S.-based companies and their foreign affiliates.

The U.S. multinational firm can be viewed as having an overall portfolio of R&D made up of domestic and foreign activities. R&D, in other words, can be performed in the United States or in a foreign location. The foreign R&D may be performed by either a foreign branch or foreign subsidiary of the U.S. firm. The costs of domestic and foreign R&D determine both the overall level of R&D and how much is performed in each location. The following sections examine the quantitative significance of each of these forces tending to reduce R&D performed in the United States, namely, (a) the reduction in domestic R&D because of the reduction in the overall, domestic and foreign, R&D effort due to increased costs and (b) the reduction in domestic R&D activity because an increased share of a given overall R&D effort is performed abroad. The results are then combined to derive the total impact of an increase in costs on U.S.-based R&D.

This analysis can be stated more precisely by expressing the determinants of the elasticity of demand for domestic R&D with respect to a change in its marginal cost. An elasticity of 1.0 in absolute value, for example, would indicate that R&D performed in the United States would fall by 1 percent in response to a 1 percent increase in its cost. It can be expressed as:

$$(1) \text{ Elasticity of demand for domestic R\&D} = uE + (1-u)S$$

where u is the share of the overall R&D expenditures by U.S.-based companies and their foreign affiliates that is incurred in the United States, E is the elasticity of demand of the overall, domestic and foreign, R&D undertaken by U.S. companies and their foreign affiliates, and S is the elasticity of substitution between domestic and foreign R&D. S is a measure of the degree of substitutability of domestic and foreign R&D in U.S. firms' overall R&D program. It is the percentage change in the ratio of domestic to foreign R&D relative to the percentage change in the ratio of domestic R&D costs to foreign R&D costs. ^{10/}

^{10/} For a full description of equations of the type used here, and the underlying assumptions, see Paul Armington, "A Theory of Demand for Products Distinguished by Place of Production," International Monetary Fund Staff Papers, 1969, pp. 159-177.

The two terms on the right hand side of the equation reflect the two forces affecting the level of domestic R&D. The first term reflects the role of an increase in domestic R&D costs in changing the scale of the overall R&D effort i.e., before the transfer abroad is considered. For example, if 92 percent of overall R&D expense is incurred in the United States, then a 1 percent increase in domestic marginal costs increases the marginal costs of overall R&D by .92 percent. The scale effect would then reduce domestic R&D by .92 percent times the elasticity of demand for overall R&D, E , as domestic R&D shares proportionally in the reduction in the total R&D.

The second term adds the impact of the change in the mix of R&D in response to changing relative costs. The $(1-u)$ applied to the substitutibility measure, S , reflects the fact that a large percentage change in the foreign share of R&D will only translate into a small effect on domestic R&D if the foreign share is initially small.

1. Impact of cost on overall R&D activity. The results of two recent econometric studies were used to estimate the impact of a change in costs on the overall level of R&D activity by U.S. firms and their foreign affiliates. One, by Lawrence Goldberg, attempts to estimate the impact of a change in R&D costs relative to the price of output on the demand for R&D. ^{11/} Goldberg developed a user cost of R&D investment, similar to the user cost of physical capital used by many investigators to study the demand for physical investment. His measure is based on the relative costs of R&D inputs and on interest rates. Goldberg found that a 1 percent increase in the user cost of R&D relative to the price of output reduced the real level of R&D expenditures in the long run by .92 percent. He concedes, however, that this finding may have been affected by the common trend in both R&D and the user cost of R&D which may have led to an overestimate of the significance of R&D costs.

I.M. Nadiri and M.A. Schankerman attempted to look at this issue using a different methodology. ^{12/} They estimated long run relationships between output on the one hand and various inputs

^{11/} Lawrence Goldberg, The Influence of Federal R&D Funding on the Demand and Returns to Investment in R&D, the Public Research Institute, CRC 388, Arlington, Virginia, October 1979.

^{12/} Ishaq M. Nadiri and M.A. Schankerman, "The Structure of Production, Technological Change and the Rate of Growth of Total factor Productivity in the Bell System" in T. Cowing, and R. Stevenson, (eds.) Productivity Measurement in Regulated Industries, Academic Press, 1981.

including R&D on the other. They find a long run price elasticity for R&D equal to .31, compared to Goldberg's estimate of .92. These two findings were used to establish a range for E in equation (1), the estimated elasticity of demand for R&D by U.S. firms and their foreign affiliates.

The Goldberg and Nadiri and Schankerman studies relate U.S. R&D activity to the cost of U.S. R&D. Their findings are used here as guides to the relationship between the demand for total, domestic and foreign, R&D and its cost. Because more than 90 percent of the R&D performed by U.S. firms and their foreign affiliates is done in the United States, this assumption does not seem inappropriate. It may be, however, that the cost elasticities estimated in the two studies may reflect some substitution between domestic and foreign R&D if U.S. and foreign costs do not move in a parallel fashion. The elasticities may therefore include part of the substitution response discussed in the second stage of the analysis. If so, the estimate of the effect of the Regulation on U.S. R&D may be overestimated.

2. Impact of costs on domestic share of R&D. This section reviews the available evidence on the amount of R&D performed by foreign affiliates of U.S. firms and attempts to evaluate the likely size of the change in the domestic share of overall R&D performed by U.S. companies and their foreign affiliates.

Table 1 contains information on the relative, U.S. and foreign, shares of privately-funded R&D. It indicates that during the period 1974-1979 there was a gradual increase in the share of R&D performed abroad by foreign affiliates of U.S. companies, but a decline after 1979. Because the post-1979 decline in the foreign share of R&D may be the result of many factors, it is difficult to identify any independent impact of the Regulation.

This section considers whether research abroad can easily substitute for research in the United States. Because there is apparently no direct evidence on shifts in the geographic location of R&D in response to changes in relative costs, it is necessary to examine more indirect evidence. One indication of how easily foreign research can substitute for domestic research is the extent to which the types of research performed overlap. If foreign and domestic research involve similar projects, then a relatively large shift abroad because of a change in relative costs might be expected. On the other hand, if foreign and domestic research have very different, specialized objectives, with little overlap in function, this would indicate that foreign countries are not likely to be efficient locations for the kind of R&D done in the United States.

Table 1

R&D Performed in the United States and by
Foreign Affiliates Outside the United States 1/

Year	R&D by Foreign Affiliates of U.S. Companies (millions of dollars)	R&D Financed by Private Industry and Performed in the United States (millions of dollars)	Foreign Share of Total Private R&D Expenditures by Foreign Affiliates and Their U.S. Companies
1974	1,300	14,667	8.14
1975	1,454	15,582	8.53
1976	1,659	17,436	8.67
1977	1,877	19,340	8.85
1978	2,209	22,115	9.08
1979	2,754	25,708	9.68
1980	3,165	30,476	9.41
1981	3,157	35,362	8.20

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Source: National Science Foundation.

The information on R&D by foreign affiliates is based on the top 200 U.S. R&D-performing companies. The R&D data in the Commerce Department's Benchmark Survey of Foreign Direct Investment for 1977 gives affiliate R&D of \$2,075 million and parent R&D of \$18,595 million. In view of the slight differences in coverage, this seems highly consistent with the NSF data.

The typology offered by Robert Ronstadt is useful in evaluating the overlap between U.S. and foreign R&D. ^{13/} He suggests that R&D units abroad can be classified into the following 4 categories:

(1) Transfer Technology Units, which adapt U.S. technology to the special characteristics of the foreign market.

(2) Indigeneous Technology Units, which develop new and improved products expressly for foreign markets.

(3) Global Product Units, which develop new products for worldwide production, including the United States.

(4) Corporate Technology Units, which generate new technology expressly for the parent corporation.

Ronstadt studied the motivation behind the establishment of 42 foreign R&D facilities by a group of seven U.S. multinationals. He found that foreign R&D operations are usually created to serve and support foreign manufacturing and that their mission evolves over time from the adaption of U.S. technology to the development of products aimed specifically at a foreign country or worldwide market.

The vast majority of R&D investments seems to follow a particular evolutionary pattern. This R&D pattern or process sees small investments made first in technical service labs in order to help transfer U.S. technology. Later, these R&D investments usually expand and evolve into organizational units seeking to develop new and improved products and processes expressly for foreign markets. Again, given the proper preconditions, these R&D investments may expand further and evolve into organizational units seeking to develop new and improved products and processes for simultaneous manufacture in several world markets. ^{14/}

Of the 42 cases studied by Ronstadt, 33 were transfer technology or indigenous technology units. In contrast, the preponderant share of domestic R&D would be in categories 3 and 4.

^{13/} Robert C. Ronstadt, Research and Development Abroad by U.S. Multinationals, Prager, New York, 1977.

^{14/} Robert C. Ronstadt, "International R&D: The Establishment and Evolution of Research and Development Abroad by Seven U.S. Multinationals," Journal of International Business Studies, Spring-Summer, 1978, p. 22.

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Therefore, only 9 of Ronstadt's 42 cases, roughly 20 percent, involved R&D that was substitutable for U.S.-performed R&D and which had the potential to be affected by the Regulation.

The relatively limited correspondence between U.S. and foreign R&D is also evident in the study by Jack Behrman and William Fischer. ^{15/} Their description of Canadian R&D is interesting because of the extensive R&D incentives offered by the Canadian Government. "In those cases where a Canadian laboratory was established, it was to take advantage of a unique Canadian market factor, or as a result of acquisition, rather than because of the incentives. As evidence of this, all of the Canadian laboratories identified in our study had R&D programs oriented to distinctly Canadian problems (such as extreme cold) or tastes, and typically had little overlap with the R&D program in the parent country." ^{16/}

This limited overlap of U.S. and foreign R&D was also found by Edwin Mansfield, David Teece, and Anthony Romeo. ^{17/} The firms in their sample indicated that, on average, one-third of their overseas research had no commercial applicability to their U.S. operations.

The economies offered by centralized R&D also reduce the mobility of R&D to foreign locations. "Perhaps the major inhibiting factor to the establishment of overseas R&D activities by most of the firms interviewed, and world market firms in particular, is their emphasis on the efficiency of centralized R&D facilities. Simply stated, 'setting up R&D around the world is an expensive way to do R&D'." ^{18/}

The observation in the above studies that a R&D facility is usually linked to a manufacturing operation has direct relevance for assessing the impact of the Regulation. The Regulation itself would probably not induce a firm to move a linked R&D-manufacturing operation abroad. If it did, the 1.861-8 benefits from moving the domestic R&D abroad (to obtain a foreign deduction) may be largely offset by having more foreign sales in the

^{15/} Jack N. Behrman, and William A. Fischer, Overseas R&D Activities of Transnational Companies, Oelgeschläger, Gunn, and Hain, Cambridge, 1980.

^{16/} Ibid., p. 102.

^{17/} Edwin Mansfield, David Teece, and Anthony Romeo, "Overseas Research and Development by U.S.-Based Firms," Economica, May 1979, pp. 187-196.

^{18/} Behrman and Fischer, op. cit., p. 23.

sales apportionment formula. The incentive provided by the Regulation is for a shift abroad of R&D unaccompanied by additional foreign manufacturing.

This can be illustrated with an arithmetic example. Consider a multinational corporation with 30 percent of its worldwide sales made abroad and 10 percent of its R&D performed outside the United States by a foreign affiliate. If the affiliate's foreign sales are in the same 2-digit SIC category as the parent's and if the parent uses the 50 percent-gross income option, the R&D allocation to foreign source income is 10.5 percent of domestic R&D or 9.45 percent of worldwide R&D. If the firm shifts one percent of its domestic R&D and one percent of its domestic production (and sales) abroad, its R&D allocation to foreign income goes up to 9.57 percent of worldwide R&D. The final after tax impact on the firm depends on the additional foreign income generated and how it is taxed abroad. Nevertheless, if a corporation paid the equivalent of the U.S. 46 percent rate on its new foreign income and if it was originally in an excess foreign tax credit position, moving a joint or linked R&D-manufacturing operation abroad would increase its worldwide tax liability.

Based on these considerations, it appears that foreign R&D is not highly substitutable for R&D performed in the United States. Perhaps one half of the 8.2 percent foreign share of overall R&D by U.S. firms and their foreign affiliates is comparable to R&D undertaken in the United States. The index of the substitutability between foreign and domestic R&D that is used in the combined estimate of the impact of domestic costs on domestic R&D activity is the elasticity of substitution. This is the percentage change in the ratio of foreign to domestic R&D divided by the percentage change in relative costs. This elasticity of substitution is assumed to be in the range of from 1 to 3 in absolute value. ^{19/} This range may overstate the degree of potential substitution in view of the earlier discussion. For example, an elasticity of substitution of 3 means that a 1 percent increase in the relative cost of domestic R&D would increase the estimated one-half of foreign R&D that is comparable to domestic R&D by more than 6 percent. Nevertheless, the 1 to 3 range is chosen so as not to underrate the possibility of a shift in the location of R&D activity.

^{19/} An elasticity of substitution of 3, for example, means that a one percent increase in domestic costs relative to foreign costs will lead to a 3 percent increase in the ratio of foreign to domestic R&D.

3. The combined response of domestic R&D activity to a change in domestic R&D costs. The response of domestic R&D activity to a change in domestic R&D costs is derived using the following information:

a. The elasticity of overall R&D, both domestic and foreign, with respect to a change in the overall marginal costs of R&D. This elasticity, E in equation (1), is assumed to range from .31 to .92 in absolute value.

b. The elasticity of substitution between foreign and domestic R&D. This is the indicator of the substitutability of domestic for foreign R&D and is assumed to be in the range from 1 to 3 in absolute value. It is S in equation (1).

c. The foreign share of overall R&D expense of U.S. firms and their foreign affiliates. It is assumed to equal 8.2 percent in 1982 (the same as in 1981) and is $1-u$ in equation (1). This share is significant because it represents the base that can be expanded because of a change in relative costs.

The combination of these factors was applied to equation (1) to produce a range for the elasticity of demand for domestic R&D of from .37 to 1.09. The upper estimate, for example, was calculated as follows:

Elasticity of demand for domestic R&D =

$$uE + (1-u)S = (.918)(.92) + (.082)(3) = 1.09$$

This range of elasticity estimates, .37 to 1.09, indicate how domestic R&D would respond to a change in costs. The estimate of 1.09, for example, indicates that U.S.-performed R&D would fall by 1.09 percent in response to a 1 percent increase in costs.

Based on 1982 private U.S. R&D spending, the estimated \$100 million to \$240 million increase in tax liabilities amounts to a cost increase of .27 percent to .65 percent. Using the estimated range in elasticities of .37 to 1.09, this would have reduced U.S. R&D by from .10 to .71 percent in 1982. ^{20/} In dollar terms, this would represent a reduction in U.S. R&D spending of from \$37 million to \$260 million.

^{20/} In this discussion, it is implicitly assumed that the percentage increase in the average costs of R&D is equivalent to the percentage increase in marginal costs. This is however consistent with the method of estimating the costs to firms of a section 1.861-8 allocation, which assumed that firms excess credit position was not affected by the allocation. The percentage increase in average costs is therefore the same as the percentage increase in the costs of the marginal dollar of R&D.

In the estimated .10 to .71 percent range of possible changes in domestic R&D, the reduction in domestic R&D simply because R&D is now a more expensive investment tends to be much more significant than the reduction in domestic R&D because of a shift of R&D activity abroad. It is only in the combination of the low overall elasticity of R&D demand equal to .31 and the high substitution elasticity of 3 that the two forces are approximately equivalent.

The relatively modest role of tax factors in determining the location of R&D appears to be supported by a recent study by Arthur Andersen and Co. In the study, 85 major firms were asked to rank the importance of various external factors in the decision to locate R&D overseas. The study reports,

The results indicate that the most common incentive for determining timing, placement, and scope of R&D projects is the competency of the available work force. The geographical location of necessary raw materials and research data was the second most frequent response. 21/

21/ Arthur Andersen and Co., National Research and Development Study, January 1983, p. V-3.

Chapter 4 - Summary and Recommendation

U.S. citizens and residents and domestic corporations are subject to U.S. tax on their worldwide income from all sources, domestic and foreign. Since income earned from outside the United States (foreign source income) is usually also taxed by the foreign country where it is earned on a source basis, the United States allows a credit for foreign income taxes.

The foreign tax credit provides U.S. taxpayers with a dollar for dollar reduction of their U.S. income tax liability. Under U.S. law and long-standing U.S. international tax policy, the foreign tax credit is limited to the U.S. tax on the foreign source income. The purpose of the limitation is to prevent foreign taxes from reducing U.S. taxes on domestic source income. That is, taxes paid to a foreign country can be used to reduce U.S. tax on income earned in that country, but not on income earned in the United States.

Foreign source taxable income, for the purpose of calculating the limitation on the credit, is measured under U.S. tax rules. Regulation 1.861-8 provides rules for the allocation and apportionment of R&D and other expenses to gross income for determining taxable income from foreign and domestic sources. The objective of the Regulation's R&D rules, which were suspended by section 223 of ERTA, is to match R&D expense with the foreign and domestic source income generated by or related to the expenditure.

The Regulation's R&D rules reflect significant modifications of the 1973 proposed regulations in response to taxpayer comments. For example, R&D aimed exclusively at meeting a U.S. government legal requirement can be allocated solely to U.S. income. Thirty percent of the remaining R&D expense can be "exclusively apportioned" to U.S. source income, provided that more than one-half the R&D is performed in the United States. The Regulation allocates R&D on a product line basis. The objective is to avoid allocating R&D expense related to one product to foreign source income earned from sales in a wholly different product category. The gross income option allows the apportionment to foreign source income to be reduced by up to one-half the amount apportioned on the basis of sales. Compared to the 1973 proposed regulation, these modifications allow less R&D expense to be allocated to foreign income and recognize that U.S. R&D may be most valuable in the domestic market. For example, the Regulation permits a taxpayer with equal amounts of domestic and foreign sales, and using the gross income option to reduce its sales-based apportionment by 50 percent, to allocate less than 20 percent of its R&D expense to foreign source income.

Any allocation of R&D expense to foreign source income will reduce taxable income and the limitation on the credit. If the foreign government does not allow the apportioned expense as a deduction, income taxes actually paid to the foreign government will not be reduced. Consequently, the allocation may increase a taxpayer's total, U.S. plus foreign, tax liability. Some allocation to foreign income, however, is appropriate on tax policy grounds when domestic R&D is exploited in a foreign market and generates foreign, as well as domestic income. If an allocation is not made, foreign source taxable income will be too high and the higher limitation may allow the credit for foreign tax to reduce U.S. taxes on domestic source income. Thus, requiring no allocation of domestic R&D expense to foreign source income attributable to the expense can best be viewed as an R&D incentive.

Compared to the Regulation, the section 223 ERTA moratorium reduces U.S. tax liabilities. If the R&D rules in the Regulation had been in effect in calendar 1982 instead of the ERTA provision, U.S. tax liabilities of U.S. firms would have been \$100 million to \$240 million higher.

All firms are not affected uniformly by the moratorium. It only reduces the tax liabilities of firms in an excess credit position. These firms earn from 16 percent to 22 percent of the worldwide income of U.S. manufacturing corporations. Whether or not a firm is in an excess credit position does not seem to be closely related to the level of its R&D effort. The moratorium has its most significant effect on large, mature multinationals, as opposed to small, relatively young, high-technology companies. It affects those R&D oriented taxpayers with relatively large amounts of foreign production and income, as opposed to those taxpayers exploiting their R&D primarily for domestic production. Of the Regulation's \$100 million to \$240 million estimated increase in additional U.S. tax liabilities, about 85 percent is estimated to be accounted for by 24 U.S. firms on the list of the 100 largest U.S. industrial corporations compiled by Fortune magazine.

This \$100 million to \$240 million increase in tax liabilities would have increased the cost of privately-financed U.S. R&D by between .27 and .65 percent, or by less than 1.0 percent. Based on assumed responses of both the overall level and geographical location of R&D to this range of cost increases, the \$37 billion in privately-financed domestic R&D spending in 1982 would have been reduced by about \$40 million to \$260 million. Most of the reduction represents a net reduction in overall R&D undertaken by U.S. corporations and their foreign affiliates, because U.S. R&D has become somewhat more expensive, rather than a transfer of R&D abroad.

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The Treasury Department recognizes that the reduction in R&D may adversely affect the competitive position of the United States. Accordingly, the Treasury supports a two-year extension of the present moratorium. This will provide Congress with an opportunity to consider the findings of this report while Congress and the Administration work to develop a coherent national program of R&D incentives.

Form 1118

(Rev. Jan. 1977)
Department of the Treasury
Internal Revenue Service

Computation of Foreign Tax Credit—Corporations

For calendar year 19..... or other taxable year beginning....., 19....., and ending....., 19.....

Employer identification number.....

☐ Section 904(d) Interest Income

☐ Dividends from a DISC or Former DISC

This form is being completed for credit with respect to:

(Use a separate Form 1118 for each type of income. See General Instruction K.)

☐ Foreign Oil Related Income (Also complete separate Schedule F, Form 1118)

☐ Income from Sources Within U.S. Possessions (limitation method) ☐ Per-country OR ☐ overall

☐ All Other Income from Sources Without the U.S.

Schedule A Taxable Income or (Loss) From Sources Without the United States

1. Name of Foreign Corporation or U.S. Possession (Use a separate line for each)		Gross Income or (Loss) From Sources Without the U.S. (Exclude Foreign Branch and Section 863(b) Gross Income—See Instructions)						10. Total (Add lines 2 through 9)	
		2. Dividends (Exclude Gross-up)	3. Dividend Gross-up (Section 78)	4. Interest	5. Gross Rents, Royalties, and License Fees	6. Gross Income from Operations of Services	7. Foreign Source Capital Gain Net Income	8. Ordinary Income or (Loss) from Partnerships	9. Other (Attach schedule)
A									
B									
C									
D									
E									
F									
G									

Totals (Add lines A through G)

Deductions (Exclude Foreign Branch and Section 863(b) Deductions—See Instructions)		11. Definitely Allocable Deductions		12. Relatable Part of Deductions Not Definitely Allocable (Attach schedule)		13. Total Deductions (Add lines 11(b) and 12)		14. Taxable Income or (Loss) of Foreign Branches from Sources Without the U.S. (Attach schedule)		15. Taxable Income or (Loss) Apportioned to U.S. Source Income under Section 863(b) (Attach schedule)		16. Total Taxable Income or (Loss) (Add lines 14 and 15)	
		a. Expenses Related to Performance of Services		b. Total Definitely Allocable Deductions (Add lines 11(b) through 11(f))									
		1. Depreciation, Depletion, and Amortization		2. Other Expenses									
A													
B													
C													
D													
E													
F													
G													
Totals													

Schedule B

PART I.—Foreign Taxes Paid or Accrued and Deemed to Have Been Paid

	3. Credit in Claimed for Taxes		4. Foreign Taxes Paid or Accrued (Attach schedule showing amounts in foreign currency and conversion rate(s) rate)	5. Tax Withheld at Source on:				6. Other Foreign Taxes Paid or Accrued on:			7. Total Foreign Taxes Paid or Accrued (Add amounts A through G)	8. Tax Deemed to Have Been Paid (From column 11)
	Paid	Accrued		a. Dividends	b. Interest	c. Rents, Royalties, and License Fees	d. Branch Income	e. Services Income	f. Partnership Income	g. Other		
A												
B												
C												
D												
E												
F												
G												

Totals (Add lines A through G)

PART II.—Computation of Foreign Tax Credit

- Total foreign taxes paid or accrued (From Part I, column 4(h), "Totals" line).
- Total taxes deemed to have been paid (From Part I, column 5, "Totals" line).
- Reduction for taxes under sections 901(e), 907(e), 1503(b), and 8038 (See also General Instruction O) (Attach schedule).
- Carryback or carryover (Attach schedule showing computation in detail) (See General Instruction M).
- Total foreign taxes (Line 1 plus lines 2 and 4 less line 3).
- Total taxable income or (loss) from sources without the U.S. (Before loss recapture) (From Schedule A, column 15, "Totals" line).
- Recapture of prior year overall foreign losses (See General Instructions L(3)).
- Line 6 less line 7.
- Total taxable income from all sources (Enter taxable income from your tax return).
- Less: Adjustments to total taxable income from all sources (See General Instructions L(2), L(4), and L(5)).
- Line 9 less line 10.
- Line 8 divided by line 11 (If line 8 exceeds line 11, enter the figure "1").
- Total U.S. income tax against which credit is allowed (After section 936 credit but before any other credit).
- Limitation (Line 13 multiplied by line 12).
- Foreign tax credit (Line 5 or line 14, whichever is less).

PART III.—Summary of Credits from Schedules F and J

- Credit with respect to section 904(d) interest.
- Credit with respect to dividends from a DISC or former DISC.
- Credit with respect to income from sources within U.S. possessions.
- Credit with respect to foreign oil related income.
- Credit with respect to all other income from sources without the United States.
- Total (Add lines 1 through 5).
- Reduction in credit for international boycott operations (See General Instruction O).
- Total foreign tax credit (Line 5 less line 7). Enter here and on your tax return.

The following lines are for the computation of tax deemed to have been paid by a first-tier foreign corporation with respect to dividends from a second-tier foreign corporation under section 902(b)(1). Enter the amounts from column 11 in Schedule C, column 9.

The following lines are for the computation of tax deemed to have been paid by a first-tier foreign corporation with respect to dividends from a second-tier foreign corporation under section 902(b)(1). Enter the amounts from column 11 in Schedule C, column 9.

[illegible]

The following lines are for the computation of tax deemed to have been paid by a second-tier foreign corporation with respect to dividends from a third-tier foreign corporation under section 962(b)(2). Enter the amounts from column 11 in Schedule D, column 9.

The following lines are for the computation of tax deemed to have been paid by a second-tier foreign corporation with respect to dividends from a third-tier foreign corporation under section 962(b)(2). Enter the amounts from column 11 in Schedule D, column 9.

[illegible]

Department of the Treasury
Internal Revenue Service

Instructions for Form 1118

Computation of Foreign Tax Credit—Corporations

(Revised January 1977)

(References are to the Internal Revenue Code and regulations thereunder.)

General Instructions

This revised form reflects changes made by the Tax Reform Act of 1976 and should only be used for calendar year 1976 and other taxable years ending after December 31, 1976.

A. Corporations Required to File Form 1118.—Form 1118 must be attached to the income tax return of any corporation electing to claim the benefits of a foreign tax credit under Section 901.

The form must be carefully filled in with all the information called for and with the calculation of credits indicated. (Section 1.905-2(a)(2) of the regulations.)

B. Foreign Taxes for which Credit May Be Claimed.—The credit may be claimed for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any U.S. possession, and the taxes deemed to have been paid or accrued under sections 902 and 960. (Section 1.901-1(a)(2) of the regulations.)

The term "foreign country" means any foreign state or political subdivision thereof, or any foreign political entity which levies and collects income, war profits, or excess profits taxes. For purposes of the credit, Puerto Rico is considered a U.S. possession. (Section 1.901-2 of the regulations.)

The term "income, war profits, and excess profits taxes" includes a tax imposed by statute or decree by a foreign country or U.S. possession if: (1) the country or possession has in force a general income tax law; (2) the corporation claiming the credit would, in the absence of a specific provision applicable to the corporation, be subject to the general income tax; and (3) the general income tax is not imposed on the corporation subject to such substituted tax. (Section 1.903-1(a) of the regulations.)

Any income, war profits, and excess profits taxes paid or accrued to any foreign country in connection with the purchase and sale of oil or gas extracted in such country is not to be considered as tax for purposes of sections 275(a) and 901 if: (1) the taxpayer has no economic interest in the oil or gas to which section 611(a) applies; and (2) either such purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale. (Section 901(f).)

No credit (or deduction) is allowed for any tax paid or accrued to a foreign country or U.S. possession with respect to tax-

able income taken into account in computing the section 936 credit. (Section 936(c).)

No credit (or deduction) is allowed for any tax paid or accrued to a foreign country or U.S. possession with respect to any distribution from a corporation to the extent the distribution is attributable to periods during which an election under section 936 or section 931 (prior to amendment by the Tax Reform Act of 1976) applied to the corporation. (Section 901(g); see section 1051(i)(2) of the Tax Reform Act of 1976 for a limited exception.)

No credit (or deduction) is allowed for any income, war profits, or excess profits taxes paid or accrued to any foreign country or U.S. possession attributable to income excluded under section 819A(a). (Section 819A(f).)

A credit is not allowed for excess tax payments to a foreign country with which the U.S. has a tax treaty if such excess would be refunded by the foreign country if a tax treaty or overpayment claim were made.

No credit is allowed for amounts representing interest or penalties. (Section 1.901-2(a) of the regulations.)

For reduction in the amount of foreign taxes for which a credit may be claimed, see General Instructions J and O.

C. Corporations Not Allowed Credit.—The credit is not allowed to: (1) a China Trade Act corporation; or (2) a regulated investment company which has exercised the election under section 853. (Sections 942 and 853(b)(1).)

D. Taxes Against which Credit is Allowed.—The foreign tax credit is allowed against income tax imposed by chapter 1 (reduced by the section 936 credit) but not against any: (1) minimum tax for tax preferences imposed by section 56; (2) tax on premature distributions to owner-employees imposed for the taxable year under section 72(m)(5)(B); (3) tax on lump sum distributions imposed by section 402(a); (4) additional tax on income from certain retirement accounts imposed for the taxable year by section 408(f); (5) tax on accumulated earnings imposed by section 531; (6) personal holding company tax imposed by section 541; (7) additional tax imposed for the taxable year under section 1333 (relating to war loss recoveries); (8) additional tax imposed for the taxable year under section 1351 (relating to recoveries of foreign expropriation losses); (9) increase in tax under section 47 (re-

lating to dispositions of investment credit property); (10) increase in tax under section 50A(c) (relating to early termination by an employer in a WIN program); and (11) tax on certain capital gains of electing small business corporations imposed by section 1378.

Foreign corporations may not take the credit against any tax imposed by section 881 on income not effectively connected with the conduct of a trade or business within the U.S.

E. No Deduction if a Credit Is Claimed.—If a corporation elects for any taxable year to claim a credit for taxes to any extent, the election will apply to income, war profits, and excess profits taxes paid or accrued in the taxable year to all foreign countries and U.S. possessions and no portion of the tax will be allowed as a deduction in the taxable year or any succeeding taxable year. (Section 1.901-1(c) of the regulations.)

The election for any taxable year may be made or changed at any time before the end of the period prescribed for making a claim for credit or refund of tax for the taxable year. (Section 901(a).)

Members of an affiliated group electing under section 243 to deduct 100% of qualifying dividends received from members of the same affiliated group are treated as one taxpayer for purposes of making the election under section 901(a). (Section 243(b)(3)(B).)

F. When Foreign Tax Credit Can Be Taken.—You can take the credit for the year in which the taxes were paid or accrued depending on the method of accounting used. However, if you report on the cash basis, you can elect to claim the credit for accrued taxes. You can make the election by checking the appropriate box in the heading for column 1 of Schedule B. This election must be followed in all subsequent years. (Section 905(e).)

G. Credit for Tax Accrued But Not Paid.—If you claim a credit for tax accrued but not paid, Internal Revenue may require you to furnish a bond on Form 1117 as a condition precedent to the allowance of the credit. (Section 1.905-4 of the regulations.)

H. Proof of Credits.—Payment or accrual of each item of foreign tax for which you claim a credit must be substantiated by attaching to Form 1118 a receipt if the tax is paid, or the foreign tax return on

which the tax is based if the tax is accrued but not paid. If such receipt or return is in a foreign language, a certified translation must also be attached. Internal Revenue may accept secondary evidence of foreign taxes paid or accrued if it can be established to its satisfaction that it is impossible to furnish a receipt, return, or direct evidence of tax withheld. (Section 1.905-2 of the regulations.)

Foreign taxes paid or accrued by a foreign corporation for which a deemed paid credit is claimed under section 902 or 960 must be similarly substantiated. (Sections 1.902-3(a)(6) and 1.960-1(f) of the regulations.)

1. Credit for Taxes of Foreign Corporations Deemed to Have Been Paid.—

(1) *Under Section 902.*—If a domestic corporation owns 10% or more of the voting stock of a foreign corporation (first-tier foreign corporation) from which it receives a dividend, the domestic corporation is deemed to have paid a proportionate amount of the foreign income, war profits, and excess profits taxes paid, accrued, or deemed paid by the first-tier foreign corporation. (Section 902(a).)

If the first-tier foreign corporation owns 10% or more of the voting stock of a second-tier foreign corporation from which it receives a dividend, and the product of the percentage of voting stock owned by the domestic corporation in the first-tier foreign corporation and the percentage of voting stock owned by the first-tier foreign corporation in the second-tier foreign corporation equals at least 5%, the first-tier foreign corporation is deemed to have paid a proportionate amount of the foreign income, war profits, and excess profits taxes paid, accrued or deemed paid by the second-tier foreign corporation. (Section 902(b)(1).)

If the second-tier foreign corporation owns 10% or more of the voting stock of a third-tier foreign corporation from which it receives a dividend, and the product of the percentage of voting stock owned by the domestic corporation in the first-tier foreign corporation, the percentage of voting stock owned by the first-tier foreign corporation in the second-tier foreign corporation, and the percentage of voting stock owned by the second-tier foreign corporation in the third-tier foreign corporation equals at least 5%, the second-tier foreign corporation is deemed to have paid a proportionate amount of the foreign income, war profits, and excess profits taxes paid or accrued by the third-tier foreign corporation. (Section 902(b)(2).)

You may not claim a credit under section 902 for taxes paid by a registered foreign investment company to which the election under section 1247(f) applies. (Section 1.1247-4(b)(2)(vii) of the regulations.)

For purposes of section 904, all foreign income taxes paid or deemed paid by a first-tier foreign corporation and deemed paid by the domestic corporation under section 902, are deemed to have been paid to the foreign country or U.S. possession under the laws of which such first-tier foreign corporation is created or organized.

Page 2

(Section 1.902-3(d)(2) of the regulations.)

(2) *Under Section 960(a).*—If a domestic corporation is required under section 951 to include in gross income an amount attributable to the earnings and profits of a foreign corporation (first-tier foreign corporation) of which it owns 10% or more of the voting stock, or of a foreign corporation (second-tier foreign corporation) of which such first-tier foreign corporation owns 50% or more of the voting stock, the domestic corporation is deemed to have paid a proportionate amount of the foreign income, war profits, and excess profits taxes paid, accrued, or deemed paid by such first-tier foreign corporation, or paid or accrued by such second-tier foreign corporation. (Section 1.960-1(c)(1) of the regulations.)

For amounts included in gross income under section 951 in taxable years beginning after December 31, 1976, a credit is allowed for taxes deemed to have been paid by a third-tier foreign corporation, and the percentage-of-voting-stock requirements are the same as under section 902.

(3) *Mixed Application of Sections 902 and 960(a).*—Section 902(b)(1) applies to all dividends received by a first-tier foreign corporation from a second-tier foreign corporation (as defined for purposes of section 960(a)) other than dividends attributable to earnings and profits of such second-tier foreign corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such second-tier foreign corporation. (Section 1.960-2(b) of the regulations.)

Section 902(a) applies to all dividends received by the domestic corporation for its taxable year from a first-tier foreign corporation, other than dividends attributable to earnings and profits of such first-tier foreign corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such first-tier foreign corporation. (Section 1.960-2(c)(1) of the regulations.)

If a first-tier foreign corporation for its taxable year receives from a second-tier foreign corporation (as defined for purposes of section 960(a)) dividends to which section 902(b)(1) applies and other dividends to which section 902(b)(1) does not apply, then in applying sections 902(a) and 960(a) with respect to the foreign income taxes deemed paid under section 902(b)(1) by such first-tier foreign corporation for such taxable year, the earnings and profits of the first-tier foreign corporation shall be considered not to include its earnings and profits attributable to such other dividends from the second-tier foreign corporation, and for purposes of so applying section 902(a), distributions to the domestic corporation from such earnings and profits which are attributable to such other dividends from the second-tier foreign corporation shall not be treated as a dividend. (Section 1.960-2(d) of the regulations.)

In taxable years beginning after December 31, 1976, computations under section 902 must also make allowance for any taxes deemed to have been paid by a

third-tier foreign corporation under section 960(a).

(4) *Entities Treated as Foreign.*—For purposes of the deemed paid credit, the term "foreign corporation" includes: (1) a DISC or former DISC (as defined in section 992(a)), but only with respect to dividends from the DISC or former DISC to the extent such dividends are treated under sections 861(a)(2)(D) and 862(a)(2) as income from sources without the U.S.; and (2) a contiguous country life insurance branch, where an amount is added to the life insurance taxable income of the domestic life insurance company by reason of section 819A(a)(2). (Sections 901(d) and 819A(f)(1)(B).)

(5) *Dividend Gross-up.*—Under section 78, taxes deemed paid by a domestic corporation under sections 902 and 960(b) with respect to distributions by a foreign corporation must be included in income as dividend gross-up if: (a) the distribution is received by the domestic corporation after December 31, 1977; (b) the distribution is made out of the accumulated profits of the foreign corporation for a taxable year (of the foreign corporation) beginning after December 31, 1975; or (c) the distribution is made out of the accumulated profits of the foreign corporation for a taxable year (of the foreign corporation) beginning before January 1, 1976 in which the foreign corporation was not a less developed country corporation. (See section 1.960-3(b) of the regulations for exceptions.)

J. Reduction in Foreign Taxes.—

(1) *Taxes on Foreign Oil and Gas Extraction Income.*—The amount of any foreign taxes paid, accrued, or deemed paid in any taxable year ending after December 31, 1974 with respect to foreign oil and gas extraction income which may be taken into account for purposes of section 901 must be reduced by the amount (if any) by which the amount of such taxes exceeds the product of the amount of foreign oil and gas extraction income for such taxable year and the applicable percentage from Section 907(a)(2). (Section 907(a).)

For computation of the reduction, see separate Schedule F, Form 1118.

(2) *Taxes on Foreign Mineral Income.*—The amount of any income, war profits, and excess profits taxes paid or accrued, or deemed paid during the taxable year to any foreign country or U.S. possession with respect to foreign mineral income derived from sources within such country or possession must be reduced by the lesser of (a) the amount of such foreign taxes minus the amount of U.S. tax computed under Chapter 1 of the Code with respect to such foreign mineral income, or (b) the amount of U.S. tax which would be computed under Chapter 1 of the Code with respect to such foreign mineral income without regard to the deduction for percentage depletion under section 613 minus the amount of U.S. tax computed under Chapter 1 of the Code with respect to such foreign mineral income. The reduction must be made on a country-by-country basis. (Section 1.901-3(a)(1) of the regulations.)

The reduction applies only if a deduction for percentage depletion under section 613 was allowed with respect to any

part of such foreign mineral income. (Section 1.901-3(a)(3)(i) of the regulations.)

A schedule must be attached showing the computation described in (a) and (b) above of the foreign and U.S. tax with respect to foreign mineral income. (Section 1.901-3(a)(3)(iv) of the regulations.)

(3) **Affiliated Groups Which Include One or More Western Hemisphere Trade Corporations.**—If an affiliated group which includes one or more Western Hemisphere trade corporations files a consolidated return, the amount of taxes paid or accrued to foreign countries and U.S. possessions by such Western Hemisphere trade corporations must be reduced by the amount (if any) by which the smaller of (a) the amount of such taxes or (b) the amount of tax which would be computed under section 1503(a) if such corporations were not Western Hemisphere trade corporations with respect to the portion of the consolidated taxable income attributable to such corporations, exceeds the amount of tax computed under section 1503(a) with respect to the portion of the consolidated taxable income attributable to such corporations. The reduction is adjusted if the Western Hemisphere trade corporations are also regulated public utilities. (Section 1503(b).)

If a Western Hemisphere trade corporation is a member of an affiliated group and derives foreign oil and gas extraction income for the taxable year, the reduction for foreign taxes with respect to such income is the greater of the reduction determined as described above applied separately to such taxes or the reduction determined as described in instruction J(1).

(4) **Failure to Furnish Return Required under Section 6038.**—For each failure of a domestic corporation to furnish any return or any information in any return required under authority of section 6038 on or before the prescribed date, in the application of sections 902 and 960, all taxes paid or deemed paid by all foreign corporations controlled by such domestic corporation must be reduced by 10%, and in the application of section 901 all taxes paid or deemed paid (except taxes deemed paid under section 904(d) and taxes reduced in the application of sections 902 and 960) by such corporation must be reduced by 10%. If such failure continues for 90 days or more after the date of written notice by Internal Revenue to such domestic corporation, the reductions are 10% plus 5% for each three-month period or fraction thereof during which such failure continues after expiration of the 90-day period. (Section 1.6038-2(f) of the regulations.)

K. Limitation on Credit.

For all taxable years beginning after December 31, 1975, the credit must be computed using the overall limitation. Under the overall limitation, the credit is limited to that percentage of the total U.S. income tax against which the credit is allowed which taxable income from sources without the U.S. (but not in excess of

total taxable income) is of total taxable income. (Section 904(a).)

The credit must be computed separately (using a separate Form 1118) for foreign taxes paid or accrued with respect to: (1) section 904(d) interest income; (2) dividends from a DISC or former DISC; (3) foreign oil related income; (4) income from sources within U.S. possessions; and (5) all other income from sources without the U.S. On each Form 1118, the credit must be computed using the overall limitation, with the following exception. If in your last taxable year beginning before January 1, 1976 you used the per-country limitation, you must continue to use it (unless you elect the overall limitation) in computing the credit with respect to income from sources within U.S. possessions. (See also section 1031(c)(2) of the Tax Reform Act of 1976 for a general exception in the case of certain mining companies.)

The limitation may be increased under section 960(b) in a taxable year in which you receive a distribution of earnings and profits in respect of which you were required under section 951 to include an amount in gross income for a prior taxable year. See section 960 and section 1.960-4 of the regulations for computation of the increase in the limitation.

L. Computation of Taxable Income.

(1) **General Source Rules.**—The determination of gross income, applicable deductions, and taxable income from sources without the U.S. and within each foreign country or U.S. possession must be made in accordance with sections 638 and 861 through 864 and the regulations thereunder, and applicable tax treaties. All income from sources without the U.S., including high seas income, must be taken into account.

(2) **Capital Gains.**—Generally, taxable income from sources without the U.S. includes gain from the sale or exchange of capital assets (including any gain so treated under section 1231) only in an amount equal to foreign source capital gain net income (the lesser of capital gain net income from sources without the U.S. or capital gain net income) reduced by three-eighths of foreign source net capital gain (the lesser of net capital gain from sources without the U.S. or net capital gain). Further, for purposes of the credit, taxable income from all sources includes gain from the sale or exchange of capital assets only in an amount equal to capital gain net income reduced by three-eighths of net capital gain, and any net capital loss from sources without the U.S. to the extent taken into account in determining capital gain net income, is reduced by three-eighths of the excess of net capital gain from sources within the U.S. over net capital gain. The term "capital gain net income" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges. (Section 904(b).)

See section 904(b)(3)(C) for gain from sources without the U.S. treated as gain from sources within the U.S. in case of sales or exchanges of certain personal property after November 12, 1975.

(3) **Recapture of Foreign Losses.**—If in any taxable year, beginning after December 31, 1975, you sustain an overall foreign loss in each succeeding taxable year you must treat as income from sources within the U.S. that portion of your taxable income from sources without the U.S. the lesser of: (a) the amount of the overall foreign loss not recaptured in prior years; or (b) 50% (or any higher percentage you choose) of your taxable income from sources without the U.S. Generally, an "overall foreign loss" is the amount by which gross income from sources without the U.S. is exceeded by the total deductions applicable to such income. However, see section 904(f) for certain losses not taken into account and special rules governing dispositions of property used predominantly outside the U.S. in a trade or business. See also sections 1031(c) and 1032(c) of the Tax Reform Act of 1976 for certain exceptions and transition rules.

See section 904(f)(4) for the determination of foreign oil related losses.

(4) **Coordination with Section 936.**—Taxable income taken into account for purposes of the section 936 credit is excluded from taxable income for purposes of computing the foreign tax credit limitation. (Section 904(b)(4).)

(5) **Foreign Corporations Claiming Credit.**—For purposes of computing the foreign tax credit limitation, taxable income includes only that taxable income which is effectively connected with the conduct of a trade or business within the U.S. (Section 906(b)(2).)

M. Carryback and Carryover of Excess Taxes Paid.

Taxes paid or accrued, or deemed paid under sections 902 and 960, to any foreign country or U.S. possession (reduced as described in General Instruction J) in excess of the applicable limitation may be carried back 2 years and then forward 5 years. The excess must first be applied to the earliest of the 7 years to which it may be carried, then to the next earliest year, etc. (Section 904(c).)

If a credit was not claimed in a taxable year to which the excess is carried, the excess is considered used in such year in the same manner as though a credit had been claimed. (Section 1.904-2(c) of the regulations.)

The carryback and carryover provisions must be applied separately to the excess with respect to: (1) Section 904(d) interest income; (2) dividends from a DISC or former DISC; (3) foreign oil related income; (4) income from sources within U.S. possessions; and (5) all other income from sources without the U.S. (Sections 904(d)(1) and 907(b), and section 1031(c)(3) of the Tax Reform Act of 1976.)

If you used the per-country limitation in your last taxable year beginning before January 1, 1976, see the transition rules in section 904(e) for computing carrybacks to years beginning before January 1, 1976 and carryovers to years beginning after December 31, 1975.

See section 907(f) for rules governing the carryback and carryover of oil and gas

extraction taxes paid or accrued in excess of the section 907(a) limitation.

N. Foreign Corporations Claiming Foreign Tax Credit.—Section 906 allows foreign corporations a foreign tax credit for income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued under section 902) to any foreign country or U.S. possession with respect to income effectively connected with the conduct of a trade or business within the U.S. The credit is not applicable, however, to the extent the tax is imposed by a foreign country or U.S. possession on income from U.S. sources solely because the foreign corporation was created or organized under the law of the foreign country or U.S. possession or is domiciled there for tax purposes.

The credit cannot be taken against any tax imposed by section 881 on income not effectively connected with a U.S. business.

For purposes of section 902(a) (relating to tax deemed to have been paid) and section 78 (relating to gross-up of dividends), a foreign corporation claiming a foreign tax credit will be treated as a domestic corporation.

O. Reduction of Credit for International Boycott Operations.—Generally, if a person or any corporation controlled by that person agrees to participate in, or co-operates with an international boycott, that person must file Form 5713 and reduce the total taxes available for credit or the credit otherwise allowable.

If the taxes specifically attributable to boycott operations can be determined, reduce the total taxes available for credit by entering this amount on Schedule B, Part II, line 3.

However, if the above determination cannot be made, compute the reduction by multiplying the credit otherwise allowable by the international boycott factor. This reduction shall be made against the credit otherwise allowable and entered on Schedule B, Part III, line 7.

For additional information, see Form 5713 and the instructions thereto.

P. Method of Reporting.—Report all amounts in U.S. dollars. If it is necessary to convert from foreign currency, attach a statement explaining how you determined the rate.

Specific Instructions for Schedules A through E

Schedule A.—Taxable Income or (Loss) from Sources Without the U.S.

All applicable columns in Schedule A must be completed line by line including the "Totals" line.

In columns 2 through 9 report all gross income or (loss) from sources without the U.S. except: (1) gross income of foreign

branches; and (2) gross income from activities described in section 863(b). In columns 11 and 12 report all deductions applicable to gross income reported in columns 2 through 9. See the instructions for columns 14 and 15 for treatment of income of foreign branches and section 863(b) income, respectively.

Report only gross income and deductions applicable to the determination of taxable income or (loss) from sources without the U.S. of the type for which Form 1118 is being completed.

Column 1.—Enter the names of all foreign countries and U.S. possessions within which income is sourced, and/or to which taxes are paid, accrued, or deemed paid.

High seas income must be shown separately and be properly identified.

Column 2.—Report all dividends (before gross-up) from sources without the U.S., including constructive distributions under section 951. See section 861(a) (2)(A) for treatment of dividends from a domestic corporation which has an election in effect under Section 936 and from other domestic corporations less than 20 percent of whose gross income is derived from sources within the U.S. See section 861(a) (2)(B) for treatment of dividends from a foreign corporation 50 percent or more of whose gross income was effectively connected with the conduct of a trade or business within the U.S.

Column 3.—Enter the dividend gross-up for taxes deemed paid. See General Instruction I(5) for an explanation of the dividend gross-up.

Column 4.—If interest is excluded from section 904(d) interest by virtue of sections 904(d)(2)(C) or 904(d)(2)(D), a schedule must be attached showing in sufficient detail the manner in which the 10% direct or indirect ownership requirements are met.

Column 5.—Include gross income, whether in the form of compensation, commissions, fees, or otherwise derived from the performance of technical, managerial, engineering, construction, scientific or similar services. Do not include gross income from services performed through a foreign branch.

Column 9.—Include all other gross income from sources without the U.S., except gross income of foreign branches and gross income from activities described in section 863(b). Attach a schedule identifying the gross income by type and by foreign country or U.S. possession of source.

Column 11(d).—Include all other deductions definitely allocable to income from sources without the U.S. (dividends, interest, etc.) except deductions allocable to income of foreign branches and section 863(b) income.

The reduction for three-eighths of foreign source net capital gain should be reported here.

Column 12.—Section 862(b) provides that a ratable part of expenses, losses, and other deductions which cannot definitely

be allocated to some item or class of gross income shall be deducted from gross income from sources without the U.S. in arriving at taxable income from sources without the U.S. Report in column 12 only that ratable part which applies to gross income reported in columns 2 through 9. Attach a schedule showing in detail the determination of this ratable part.

Column 14.—Attach a schedule showing in detail the determination of taxable income or (loss) of each foreign branch. The schedule should include, for each foreign branch, an income statement, balance sheet, and schedule of midyear remittances.

Column 15.—Section 863(b) and the regulations thereunder provide special rules for determining taxable income from sources without the U.S. with respect to gross income derived partly within and partly without the U.S. Report in column 15 taxable income or (loss) apportioned to sources without the U.S. under these special rules. (Taxable income of foreign branches from sources without the U.S. determined under these special rules should be reported in column 14, not column 15.) Attach a schedule showing gross income, definitely allocable deductions, the ratable part of deductions not definitely allocable, and the apportionment of taxable income to sources within and without the U.S.

Schedule B

Part I.—Foreign Taxes Paid or Accrued or Deemed to Have Been Paid.

All applicable columns in Schedule B, Part I must be completed line by line including the totals line.

Report only foreign taxes paid or accrued and deemed paid with respect to the type of income for which Form 1118 is being completed.

Column 1.—If you claim a credit for taxes accrued, show both the date accrued and the date paid (if paid). (See General Instruction F.)

Column 2.—Enter the type of tax (income, war profits, or excess profits).

Column 4.—Enter foreign taxes paid or accrued on the line for the country or U.S. possession imposing the tax. Report all amounts in U.S. dollars. If amounts were converted from foreign currency, attach a schedule showing in detail how the conversion rates were determined. See General Instruction H for proof of credits required.

Include in column 4(g) tax withheld at source on income other than dividends, interest, rents, royalties, and license fees, and all other foreign taxes paid or accrued. Do not include taxes deemed to have been paid, which are reported in column 5.

Column 5.—Enter the tax deemed to have been paid to each foreign country or U.S. possession from column 11, Schedule C.

Part II.—Computation of Foreign Tax Credit.

Use a separate Schedule B, Part II for each U.S. possession if you are using the per-country limitation method for computing the credit with respect to income from sources within U.S. possessions.

Part III.—Summary of Credits from Separate Forms 1118.

Complete Schedule B, Part III on only one Form 1118. Enter the credits from Schedule B, Part II, line 15 of the separate Forms 1118 on lines 1 through 5 as appropriate.

Schedule C.—Computation of Taxes Deemed to Have Been Paid by Domestic Corporation Filing this Return

Column 2.—If dividends are from the accumulated profits of more than 1 year, the tax deemed to have been paid must be computed and shown on a separate line for each year.

Computations under section 902(a) and 960(a) for a first-tier foreign corporation, even though for the same year, must be made on separate lines. Further, separate lines must be used for computations under sections 902(a) and 960(a) with respect to the foreign income taxes deemed paid by a first-tier foreign corporation under section 902(b)(1). (See General instruction I(3).)

Column 3.—If computation is for a second-tier or third-tier foreign corporation under section 960(a), also indicate (in parentheses) the country of incorporation of the first-tier foreign corporation of such second-tier or third-tier foreign corporation.

Column 5.—See General Instruction H for proof of credit required, and General Instruction J(4) for reduction of foreign taxes for failure to furnish information required under section 6038.

Column 6.—See General Instruction I(3) for exclusions from the earnings and profits of a first-tier foreign corporation for purposes of applying sections 902(a) and 960(a) with respect to the foreign income

taxes deemed paid by such first-tier foreign corporation under section 902(b)(1).

Column 7.—Enter the amount of dividends: (1) paid or constructively distributed by the related foreign corporation to the domestic corporation; and (2) paid or deemed distributed by the DISC or former DISC to the domestic corporation.

See General Instruction I(3) for certain distributions made by a first-tier foreign corporation to the domestic corporation which are not treated as dividends for purposes of applying section 902(a) with respect to the foreign income taxes deemed paid by such first-tier foreign corporation under section 902(b)(1).

For purposes of section 902, Internal Revenue may determine from which year's accumulated profits the dividends were paid. In making the determination, Internal Revenue will, unless it is otherwise established to its satisfaction, treat any dividends which are paid in the first 60 days of any taxable year as having been paid from the accumulated profits of the preceding taxable year or years, and will treat dividends which are paid after the first 60 days of any taxable year as having been paid from the most recently accumulated profits.

Column 8.—For dividends paid by a foreign corporation out of accumulated profits of a year for which the foreign corporation was a less developed country corporation, disregard the instruction in the column heading and enter the amount determined by multiplying column 5 by column 6 and dividing the result by the gains, profits, and income for the year.

The gains, profits, and income is determined by the gains, profits, and income from all sources, whether or not subject to foreign tax, for the year from which the dividends (column 7) were paid.

Schedule D.—Computation of Tax Deemed to Have Been Paid by First-tier Foreign Corporations

Column 1.—Enter the name of the second-tier foreign corporation and its related first-tier foreign corporations.

Column 2.—If dividends are from the accumulated profits of more than 1 year,

the tax deemed to have been paid must be computed and shown on a separate line for each year.

Column 8.—Same instructions as Schedule C.

Column 7.—Enter the amount of dividends paid by the second-tier foreign corporation to the first-tier foreign corporation to which section 902(b)(1) applies. (See General instruction I(3).)

Column 8.—Same instructions as Schedule C.

Column 11.—Carry the amount of tax deemed to have been paid to Schedule C, column 9 and enter on the line for the related first-tier foreign corporation.

Schedule E.—Computation of Tax Deemed to Have Been Paid by Second-tier Foreign Corporations

Column 1.—Enter the name of the third-tier foreign corporation and its related second-tier foreign corporation.

Column 2.—Same instructions as Schedule D.

Column 5.—Same instructions as Schedule C.

Column 7.—Enter the amount of dividends paid by the third-tier foreign corporation to the second-tier foreign corporation.

Column 8.—Same instructions as Schedule C.

Column 10.—Enter the amount from column 8.

Column 11.—Carry the amount of tax deemed to have been paid to Schedule D, column 9 and enter on the line for the appropriate year of the related second-tier foreign corporation.

Schedule F.—Computation of Reduction of Oil and Gas Extraction Taxes

Attach Schedule F (Form 1118) if you derived any foreign oil and gas extraction income during the taxable year.

Mr. DORGAN. Thank you, Mr. Chapoton.

Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

What bothers me the most after hearing Mr. Kingson and you reaffirmed it in your testimony, is that part of the discrimination taking place here is that the companies operated in foreign countries that have a very high tax base or consequence to those companies doing business there, are the ones that draw the largest benefit.

Mr. CHAPOTON. From the suspension?

Mr. ANTHONY. Yes.

Mr. CHAPOTON. That is correct.

Mr. ANTHONY. If you could categorize what Mr. Dorgan said as a disguised form of revenue sharing, then we are having revenue sharing from the United States to those countries with the highest tax base.

Is that an accurate reflection of what happens? Who are the countries that really have those highest tax bases? Are they the developing countries, the developed countries or is it a mix of the two?

Mr. CHAPOTON. I think the countries we are talking about having discriminatory practices are the developed countries for the most part.

Mr. ANTHONY. Developing?

Mr. CHAPOTON. Developed. You wouldn't find it in the rate structure as much as in refusal to allow deductions for R&E conducted here or cost sharing payments or royalties back to the parent company in the United States.

Mr. ANTHONY. We all agree that the United States is far ahead of the rest of the world in defining an 861 problem.

Mr. CHAPOTON. That is right.

Mr. ANTHONY. If we agreed with you and postpone it for 2 more years, what strides could be made to educate other countries so that they would take a closer look at the 861 problem within their country? There needs to be some coordinated efforts between the countries regarding tax treaties so that problems could be smoothed out a little.

Mr. CHAPOTON. That would be the desirable result clearly, Mr. Anthony. I think you are focusing on exactly the right problem. We have to recognize as long as the discrimination exists some of the firms who are affected by it will find it more costly to perform R&E and that is our concern. Though they are large firms, I think Mr. Shannon makes the point that large firms do a lot of R&E in this country, R&E will be more expensive and that is the problem we have.

The problem disappears if the foreign companies would allow the deduction or allow the royalty or cost sharing payment back to the United States.

As far as educating the foreign countries, we of course do have treaty discussions with most of our trading partners from time to time. I would not hold out any great hope that we would be able to accomplish a great deal in a 2-year period but that effort is worth while and I think should be undertaken.

Mr. ANTHONY. Barring the fact you don't think we can make any progress, what would Treasury hope to accomplish with the 2-year postponement?

Mr. CHAPOTON. It is more an attempt on our part to see the efficiency of this incentive. Once we recognize that the suspension of the allocation is an incentive for R&E, to see if that is the most efficient way in terms of lost Federal tax revenues for R&E results.

Mr. ANTHONY. Do you think, also, during that 2 years we could determine whether Mr. Shannon's solution or someone else's is correct, and that we could save or create more jobs here?

Mr. CHAPOTON. To the extent we reduce domestic R&E we are reducing jobs in that area. Now, on a macroeconomic effect I would not say it reduces jobs in the whole country that much and we do question whether the result will be to send R&E activity abroad in any significant degree.

But the effect on that area clearly will be reduction in jobs.

Mr. ANTHONY. You are saying that given a couple more years, you would have much more data to determine the efficiency of how it has operated?

Mr. CHAPOTON. That is correct.

Mr. ANTHONY. And you would come forward with a recommendation to make it permanent or a recommendation to change it?

Mr. CHAPOTON. That is correct.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. DORGAN. Mr. Duncan.

Mr. DUNCAN. I have no questions.

Mr. DORGAN. Mr. Thomas?

Mr. THOMAS. Thank you, Mr. Chairman.

In terms of the 2-year moratorium you discussed, I believe a partial response to the question was that in the 2 years you could at least examine the suspension to see if it is the most appropriate procedure.

In the Department's report on the impact, the concluding paragraph, the final sentence was, this will provide Congress with an opportunity to consider the findings of this report while Congress and the administration work to develop a coherent national program of R&D incentives.

From your perspective a 2-year suspension, continuation of present policy, is a response to the current situation but is it from your perspective the most appropriate response?

Mr. CHAPOTON. Yes, Mr. Thomas, we are spending quite a bit of time now studying this and meeting with groups, with the National Science Foundation and there is an interagency working group to study the R&E incremental tax credit enacted in 1981. It is part of the whole picture. If we give ourselves more time to look at this problem as a part of the overall incentive effort in the code, I think it is appropriate.

Mr. THOMAS. What do you expect to occur? This is in part a repeat of Mr. Anthony's question, with the 2-year extension of the moratorium? What do you expect in terms of findings or action on the part of the administration or Congress that would work toward a coherent national program of R&D incentives, and is the 2-year period a rational one to assume that a coherent national program

on R&D can be developed? You say R&D here and R&E in your testimony, we always called it R&D.

Mr. CHAPOTON. For tax law purposes, we are talking about R&E though we drift into R&D.

Mr. THOMAS. With the rest of the world, it is R&D.

Mr. CHAPOTON. I think it is a realistic time. We plan to have recommendations on the credit for domestically performed R&E certainly well within that period and this is just part of that picture.

Mr. THOMAS. The assumption would be that it would be significantly different than a continued moratorium?

Mr. CHAPOTON. I wouldn't want to make an assumption. I would have to say in the scale of things the moratorium is quite small compared to the credit. So it is a minor part of the picture though it does have revenue impact and it does have an incentive impact and one needs to be sure whether it is an efficient device.

Mr. THOMAS. If in the overall picture it is a relatively insignificant area, how much damage would a permanent moratorium do to developing a coherent national program of R&D incentives?

Mr. CHAPOTON. It does less damage than if it were significant obviously. We are concerned—and I think this committee should be properly concerned—about the point that Mr. Kingson made that we are in effect conceding to the foreign countries a discriminatory tax practice that we should put pressure to resist. That is a different question than the incentive effect or the disincentives of leaving the regulations in place.

Mr. THOMAS. But if it were—if the position were pushed for a permanent moratorium its significance would become more or less significant?

Mr. CHAPOTON. It is, I repeat, as compared to the credits not significant. I think the significance—

Mr. THOMAS. It is not significant, OK. My question is if there were people looking for some kind of a position to adhere to—and there are some of us who wind up with yes and noes in this world rather than laying out the choices—what incentive is there for people to assume that a 2-year moratorium is preferable to a permanent moratorium at this time that would let you work around that rather insignificant area when you are working on your coherent national program of R&D?

Mr. CHAPOTON. Well, that is a matter of choice. I say if you make it permanent you are deciding that the incentive is worthwhile. We have not decided that fact yet.

Mr. THOMAS. Thank you, Mr. Chairman.

Mr. DORGAN. Mr. Chapoton, a couple of questions. I am trying to get a feel for how many jobs we are talking about that might be at risk in this country if you forced R&D expenditures for tax purposes to follow income or economic activity in an absolute way. How many jobs are we talking about here?

Mr. CHAPOTON. Mr. Chairman, I cannot say how many jobs. I guess we could try to estimate how many jobs in the particular segment, R&E activities, because we estimate the reduction within a range of \$40 to \$110 million in R&E. So I think one could translate that into jobs lost in that area.

We could not possibly conclude, however, that it is a loss of jobs in the overall economy because other things happen. You have the

effect on total receipts of the Nation, you have less demand for capital in that area, just too many factors are involved.

Mr. DORGAN. The difficulty here is that with respect to the question of what is good tax policy we all can take a look at the facts and try and make judgments of what makes good sense in the area of tax policy. With respect to the question of what makes good sense from an economic standpoint, what is good economic policy if they happen to be different in the minds of some of us, you cannot make a judgment on what is good economic policy if you don't know the numbers of people who are involved and if you cannot evaluate what we would spend in order to save x jobs.

What lost revenue might we expect in order to save 200 jobs from flight from the United States to Germany, for example? It is very difficult to begin to try to evaluate the economic questions from a policy standpoint if you don't have those numbers. Is there any way of getting them?

Mr. CHAPOTON. Mr. Chairman, one moment, please.

Mr. Dorgan, we could translate the reduced R&D into a range of jobs into that sector. We would emphasize the point that I have already made that that does not suggest a change of employment in the Nation. It does not suggest macroeconomic effects.

Any time we give a tax incentive or indeed any incentive in a particular area, more capital will flow there and more jobs will be created there. We know that, we do it all the time.

The question we always have to evaluate is the efficiency of it.

Mr. DORGAN. That is my point. What is the efficiency of doing this? Do you give away \$100 million and save 50 jobs? If so, that is not the spending we would want to do in tax expenditures. But since there are no numbers available it is almost impossible to make a judgment about economic policy.

You used the word "incentive". I think you make the same assumptions many of us make that has probably led to the kind of difficulties we have throughout the IRS Code. That is that there is tax policy on the one hand and behavior on the other.

To change one is to modify the other inexorably.

Our inclination to do that in virtually every area has destroyed any semblance of fairness or coherence in our tax code, unfortunately. When you talk about incentives if you pick out R&D, I am wondering if we say research and development is important, and we understand that it is, we agree with that, and if Germany says so and Great Britain and ultimately we all develop the same basic type or same depth of incentives in our tax code for encouragement of R&D activities incountry, doesn't that incentive become pretty much like IDBs have become around the country?

Doesn't matter much where K-Mart builds you will get them in Bismarck or Boise. Doesn't this become something that proliferates to every country and then it becomes a wash?

Mr. CHAPOTON. I think you are making the point that the firm does not have the incentive to relocate.

Mr. DORGAN. Right, if everybody has the incentive.

Mr. CHAPOTON. But it does encourage capital in that area throughout the world, so it has the effect of moving capital into the area given the incentive.

Mr. DORGAN. I just read a study recently and I don't know if I have it here, but a study on that subject was of what the 25-percent credit has done to R&D expenditures in this country and I don't think it drew the conclusion that you did, that incentives necessarily provide the inflow of capital.

Mr. CHAPOTON. I am not sure I know of the study, I didn't use the word "dramatic". We are trying to determine now, the effect, if we can, of the R&E tax credit and it is difficult to do. Your proper base would be the R&E activity that would have occurred absent the credit and that is a fact we will never know.

Mr. DORGAN. Just one other question.

For a number of years I have been working with the Treasury Department on the issue of the unitary tax approach that State governments have used in taxing multinationals that do business in the States. Our Treasury Department as you know has treaties with many other governments and we have been fairly aggressive in developing concerns and manifesting those concerns in various ways about what our State governments do relative to a Royal Dutch Shell doing business in one of our States.

When we talk about the discrimination that exists in foreign governments given the fact we have tax treaties there, is there the same kind of interest and same activity and same aggressiveness applied by Treasury in trying to deal with that discrimination in foreign governments?

Mr. CHAPOTON. Yes. We attempt to deal with areas of discrimination. Any time we negotiate a tax treaty that is a primary effect of it. We have problems, and I think Mr. Kingson mentioned the problem with Germany right now, which is ongoing.

Mr. DORGAN. Have we not done well?

Mr. CHAPOTON. No, I think we have done well. We have not been completely successful. In the German case we are in a situation where we have a significant problem that we think needs to be resolved and it has been ongoing for some 5 years. But by and large I think we are aggressive and I think we do pretty well. But we certainly don't accomplish as much as we would like to all the time.

Mr. DORGAN. Well, in closing I would really appreciate getting as much information as I could from Treasury on the amount of revenue foregone and the number of jobs that we are talking about.

[The information follows:]

National Science Foundation data indicates that the estimated \$40 to \$110 million reduction in R&E in 1982 would have reduced the number of scientists and engineers employed in the affected firms by about 400 to 1,100. In addition, the cutbacks in the employment of support personnel may be in the same range.

Mr. DORGAN. Having worked in the field of apportionment and allocation in multinational income in the States and in other countries for many years, I know there are legitimate areas of concerns where corporations dealing in more than one State or more than one country get whipsawed back and forth by conflicting rules and so on.

But I know more often than not, the multinational corporations want to pick and choose, they want to pick apportionment in one jurisdiction and allocation in one other so that less than a whole is allocated for the tax base in the areas they do business.

I am interested in determining the real facts and what the real story is. If there is an advantage, we should provide incentives to keep the R&D and jobs here, but we want to do that only if it makes good sense and only if it is relatively efficient as a way of getting it done.

Mr. CHAPOTON. We agree, Mr. Dorgan.

Mr. DORGAN. Mr. Thomas.

Mr. THOMAS. On that point, when you talk about an attempt to estimate what the reduction would have been in R&E if the moratorium were not in place and it is somewhere between 100 million and 200 million. What is contained in that number? Is that plant? Is that projects? Labor?

Mr. CHAPOTON. We take R&E figures from companies reported by them and we can apply to that an increased cost. This increased cost would be an increased tax cost and then you can estimate or attempt to estimate the effect on that activity. It is scientific in the sense you are working with numbers but you have to estimate the decisions that would be made by the companies on this expenditure if you make it more costly.

Mr. THOMAS. Thank you.

Mr. DORGAN. One other point.

I did find the article I was looking for and it was from Business Week, September.

Mr. CHAPOTON. I saw that.

Mr. DORGAN. It suggests something different than you implied. Twenty-five percent tax credit for R&D expenditures enacted as part of the 1981 Recovery Act so far failed to increase R&D spending. The companies increased R&D spending by three-tenths of 1 percent in 1981 and 1 percent in 1982—amounts well below expectations.

Let me just make the point he makes at the end, the fellow, who was Mr. Mansfield, University of Pennsylvania, who did the survey, said that:

R&D expenditures for tax reporting purposes will show bigger rises but this is the result mainly of reclassification of spending into R&D categories. When a man is sent down to fix the boiler to repair it. If he repairs it, it is maintenance. If he can't repair it, it is R&D.

The reason I raise the issue is that you suggested there is this relationship always between the tax incentive or tax credit and behavior. I am saying that is not always the case.

Mr. CHAPOTON. Well, I think the question is how large the effect is. I think it is reasonable to assume, if you give an incentive and it is in the code or otherwise, then some more of that activity will be performed than would have been performed absent the incentive. The question is, is it enough to justify the cost of the incentive to the Federal Government?

Mr. DORGAN. Could we expect to get very soon an analysis of the economic impact as best you can? I understand the difficulty but you understand the problem we have.

Mr. CHAPOTON. Yes, I understand the decision you have to face. The report is our analysis to date of the impact of the R&E moratorium. These are the facts you need, the tax cost and probable effect of that cost on domestically performed R&E.

We can translate that into jobs with the caution I would make that it would not be the macroeconomic effect on jobs. Then I think one has to weigh whether the incentive is sufficient.

Mr. DORGAN. We appreciate that. I hope you will give us your best shot. Any idea when we will get that?

Mr. CHAPOTON. We can give you, the translation into jobs within a couple weeks.

Mr. DORGAN. We would appreciate that.

Chairman RANGEL. Thank you, Mr. Secretary. We would hope you send this information. If we support the administration, certainly the solution will be a temporary one.

Mr. CHAPOTON. Yes.

Chairman RANGEL. It may appear to be a political one. The quicker the subcommittee or rather the full committee can find some permanent solution to this in order to encourage research and development for all of our corporations rather than for a selected few, it would make for better tax policy and protect the members as they try to protect their constituents.

Mr. CHAPOTON. Yes, sir.

Chairman RANGEL. Thank you.

Are there any other questions?

If not, let me thank you for your testimony.

I will resume the chair by calling Gary Hufbauer, Institute of International Economics, Washington; and Larry Lokken, from my alma mater, New York University.

STATEMENT OF GARY HUFBAUER, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C.

Mr. HUFBAUER. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Hufbauer, I assume we have your statement.

Mr. HUFBAUER. Yes.

Chairman RANGEL. You may proceed as you would find convenient.

Mr. HUFBAUER. Thank you, Mr. Chairman.

I am appearing today on my own behalf at the invitation of the committee. My remarks deal with events 7 years ago.

As director of the International Tax Staff in 1976 I led a small Treasury team that drafted, redrafted and redrafted again the proposed regulations on 861 which eventually became the final regulations.

Chairman RANGEL. I am sorry, we are having difficulty hearing you. Could you talk directly into the mike.

Mr. HUFBAUER. Yes, sir.

As I said, I led a small team in 1976 that drafted and drafted and drafted again these proposed regulations that became the final regulations.

To me this experience was a great education. I learned that an interagency committee—we had an EPB Committee—faced with a difficult question could, if left to its own devices, outlive Methuselah. I learned that the mental rigidity of the Internal Revenue Service could shame a medieval theologian. I learned that, in the right cir-

cumstances, the tax bar can be more attentive than yellow jackets at a picnic.

My education hasn't stopped. Since the section 861 regulations were issued in final form on January 3, 1977, I have learned that criticism can come from unexpected quarters. I thought we would be pilloried for engineering a massive giveaway to the multinationals. As it turned out, we were accused of driving R&D from American shores.

Let me go back to the beginning and try to state the purpose of section 861, recalling that Charles Kingson has given a very able summary.

The starting point is the ambitious U.S. claim to tax the income of its citizens and corporations on a worldwide basis. Starting with this claim, the United States has had to make very major concessions in order to avoid imposing a devastating burden of double taxation on U.S. corporations that do business abroad and are correspondingly taxed by foreign countries. The most important concession the United States makes is to allow a credit for certain taxes paid to foreign countries on foreign source taxable income.

This in turn raises the question of defining foreign source taxable income. And that in turn leads to section 861, which sketches out what items of expense, incurred in the United States, should be attributed to foreign source gross income for purposes of calculating foreign source taxable income.

After many years of thinking about the U.S. system of taxing foreign source income, I am convinced that it entails a great deal of complexity to raise very little revenue. It should not be beyond the wit of man, or the wisdom of Congress, to devise a simpler method of raising the same small amount of revenue from the overseas activities of U.S. corporations. But it was not my task in 1976, nor is it my task today, to redesign the U.S. system of taxing foreign source income.

My task then was to fit section 861 into the basic architecture of the U.S. system.

As I indicated—and as Mr. Kingson indicated—section 861 is concerned with determining what expenses, incurred in the United States, should be deducted from foreign source gross income to determine foreign source taxable income. Foreign source taxable income is an important concept because it defines the foreign tax credit limit. Broadly speaking, the U.S. corporation can claim a credit for foreign taxes paid up to but not exceeding the limit.

If more expenses are attributed by U.S. tax authorities to foreign source gross income then foreign source taxable income is smaller and hence the foreign tax credit will be reduced. If a U.S. corporation and its foreign subsidiary pays taxes in an amount that equals or exceeds the foreign tax credit limit then the limit and not the tax actually paid will determine the foreign tax credit that can be claimed for U.S. tax purposes. That situation defines an unhappy corporation.

Nevertheless, approaching the question from the standpoint of the Treasury Department, it seemed obvious in 1976 that R&D findings derived from U.S. corporate expenditures might well be exploited abroad by foreign sister or subsidiary corporations. The R&D findings might have been transferred on a royalty-free basis,

perhaps as a contribution of capital, or they might have been licensed for a royalty.

Whatever the mode of transfer, if there was some use abroad of R&D findings generated in the United States, the statutory language of section 861 seemingly compelled the Treasury Department to attribute some R&D expense to foreign source income.

In a world of tax harmony, if certain R&D expenses are attributed by the United States to foreign source income, those same expenses should also be recognized by the foreign country as a deduction against income. As a deduction, they should serve to reduce foreign income taxes. But we do not live in a world of tax harmony.

Through a long process of negotiating tax treaties, the industrial countries have reached broad agreement on the boundaries that separate gross income earned in one country from gross income earned in another country. Much less agreement has been reached on the proper attribution of expenses. In particular, there is very little agreement as to whether R&D expenses incurred in one country may be attributed to gross income earned in another country. Moreover, as between the industrial countries and the developing countries, there are still substantial disagreements as to which items of gross income are properly sourced in each country.

If countries could reach agreement on proper income source rules and expense attribution rules, then no item of income would be claimed as domestic source income by more than one country, and each item of corporate expense would reduce taxable income someplace in the world. But in today's imperfect world, many nations simply disallow, as a deductible expense of the corporate taxpayer, any money spent on R&D work performed outside the national boundaries.

Moreover, some countries disallow a deduction for royalty payments made to foreigners; many countries strictly control royalty payments made by a domestic corporation to a foreign sister or parent corporation; and many countries impose high withholding taxes, 15 percent or more, on royalty payments made to foreigners. In the absence of a section 861 allocation, these various restrictive practices would serve to deny the U.S. Treasury much chance of recouping any tax revenue from income earned on the exploitation abroad of research conducted in the United States.

In the face of these attitudes, the United States has two basic policy choices: One, the United States can decide that some portion of R&D expense should be attributed to the corporation's foreign source gross income, no matter whether foreign countries will allow a deduction for all or part of the attributed expense.

Or two, the United States can decide that, both to encourage R&D activity in the United States and to remove a cause of tax disharmony with foreign countries, the United States will attribute all R&D expense incurred domestically to United States source income, regardless whether some of the R&D findings are used overseas.

In 1921, Congress chose the first policy when it enacted section 861. In 1981, Congress chose the second policy when it enacted section 223(b) of the Economic Recovery Tax Act.

The language used by Congress in 1921 to carry out its policy was rather general, and probably took no more than a day or two

to draft. When it came time, some 45 years later, to give that language concrete meaning, it took 12 years to reach a set of final regulations. Why was the task so difficult? It was difficult because there are no clear cause-and-effect accounting rules for linking R&D expense incurred by one corporation, in one country, at one point in time, to income earned by another corporation, in a different country, at a different point in time.

In the face of this difficulty, why didn't the Treasury leave well enough alone? The reason was that the day-to-day administration of the section 861 rules was rapidly approaching chaos. Different corporations and different revenue agents were developing their own allocation theories. In time, these conflicting theories would have been litigated in the Tax Court, in the district courts, in the Court of Claims, and in the circuit courts. The foreseeable result? A patchwork of conflicting decisions that would have taken decades to emerge and more decades to sort out.

The details—and some of the drama—of the debate that raged in the Treasury halls in 1976 are captured in six memoranda that I have attached to this statement.

As Congress considers extending, or making permanent, the 1983 ERTA moratorium on section 861 as applied to R&D expense, it seems to me that two sets of questions deserve consideration.

First, what are the respective roles of the section 861 allocation rules, and the 25 percent tax credit for incremental R&D expense, in encouraging U.S. corporations to perform a larger total level of R&D activity and to perform a larger share of that activity within the United States? Does the United States need two tax tools; namely, the incremental R&D credit and the section 861 moratorium to accomplish the commendable result of stimulating private research activity?

Second, wouldn't the world be better off if tax authorities in each country recognized some portion of R&D expense incurred abroad as a legitimate corporate deduction? Conversely, if this sort of recognition cannot be accomplished, isn't the next step for the United States to disallow—for purposes of computing U.S. source taxable income—R&D expenses incurred abroad? But doesn't that sort of retaliation amount to "tax protectionism"; namely, using the tax system to protect economic activity performed at home and to discriminate against activity performed abroad? One can then ask, isn't tax protectionism inconsistent with the basic U.S. commitment to a liberal world trading order?

With these kinds of questions in mind, Congress might eventually decide to require some allocation of domestic R&D expense to foreign source income. However, if and when it takes that step, Congress might simultaneously give the Treasury Department discretionary authority to disallow—as a deduction for computing U.S. taxable income—selected expenses incurred in those individual foreign countries that refuse to give appropriate recognition to R&D expense incurred in the United States. Armed with this stick, the goals of section 861 might ultimately be accomplished.

Thank you, Mr. Chairman, for this opportunity to review a page of tax history.

[The prepared statement of Mr. Hufbauer follows:]

STATEMENT OF GARY CLYDE HUFBAUER, SENIOR FELLOW, INSTITUTE FOR
INTERNATIONAL ECONOMICS, AND COUNSEL, CHAPMAN, DUFF & PAUL

SECTION 861 REGS—SEVEN YEARS ON

Mr. Chairman, I am appearing today on my own behalf at the invitation of the committee. My remarks deal with events seven years ago. In 1976, the drafting of regulations designed to interpret Section 861 caused much excitement among international tax experts. Mind you, we at the Treasury did not come to the regulation project with the sense of discovery felt by Christopher Columbus. Regulations had earlier been floated in 1965, 1966, and 1973. Thus, the 1976 effort was the Treasury's fourth attempt at crossing hazardous seas. As Director of the International Tax Staff in 1976, I led a small Treasury team that drafted, redrafted, and redrafted again the proposed regulations. Our work was reviewed by the very able Assistant Secretary for Tax Policy, Charles M. Walker, and policy decisions were ultimately taken by Treasury Secretary William Simon.

To me, this experience was a great education.

I learned that an interagency committee faced with a difficult question could—left to its own devices—outlive methuselah.

I learned that the mental rigidity of the Internal Revenue Service could shame a medieval theologian.

I learned that, in the right circumstances, the tax bar can be more attentive than yellow jackets at a picnic.

My education hasn't stopped. Since the Section 861 regulations were issued in final form on January 3, 1977, I have learned that criticism can come from unexpected quarters. I thought we would be pilloried for engineering a "massive give-away" to the multinationals. As it turned out, we were accused of driving R&D from American shores.

Let me go back to the beginning and try to state the purpose of Section 861.

The starting point is the ambitious U.S. claim to tax the income of its citizens and corporations on a worldwide basis. Starting with this claim, the U.S. has had to make very major concessions in order to avoid imposing a devastating burden of double taxation on U.S. corporations that do business abroad and are correspondingly taxed by foreign countries. The most important concession the U.S. makes is to allow a credit for certain taxes paid to foreign countries on "foreign source" taxable income. This in turn raises the question of defining foreign source taxable income. And that in turn leads to Section 861, which sketches out what items of expense, incurred in the United States, should be attributed to foreign source gross income for purposes of calculating foreign source taxable income.

After many years of thinking about the U.S. system of taxing foreign source income, I am convinced that it entails a great deal of complexity to raise very little revenue. It should not be beyond the wit of man, or the wisdom of Congress, to devise a simpler method of raising the same small amount of revenue from the overseas activities of U.S. corporations. But it was not my task in 1976, nor is it my task today, to redesign the U.S. system of taxing foreign source income. My task then was to fit Section 861 into the basic architecture of the U.S. system. I presume you are interested in that same question this morning.

As I indicated, Section 861 is concerned with determining what expenses, incurred in the United States, should be deducted from foreign source gross income to determine foreign source taxable income. Foreign source taxable income is an important concept because the following equation defines the maximum allowable foreign tax credit (that is, the foreign tax credit limit):

(1) Maximum allowable foreign tax credit equals foreign source taxable income divided by worldwide taxable income multiplied by tentative U.S. tax on worldwide taxable income.

Where:

(2) Foreign source taxable income equals foreign source gross income minus expenses attributed to foreign sources.

The purpose of the limit expressed in formula (1) is to prevent foreign taxes from eroding the U.S. Treasury's claim to tax domestic source income. Broadly speaking, a U.S. corporation can claim a credit for foreign taxes paid up to the amount of the limit. Inspection of formulas (1) and (2) reveals that, if more expenses are attributed by the U.S. tax authorities for foreign source gross income, then foreign source taxable income will be smaller, and hence the maximum foreign tax credit will be reduced. If a U.S. corporation and its foreign subsidiaries pay foreign taxes in an amount that equals or exceeds the foreign tax credit limit, then the limit—not the amount of foreign taxes actually paid—determines the foreign tax credit that can be

claimed for U.S. tax purposes. When the limit determines the credit, "excess" foreign tax credits are created, and if the excess credits cannot be used in the next few years, they may eventually expire unused. Under these circumstances, the corporation will find itself paying more U.S. taxes as a result of a greater attribution of expenses to foreign source income. In other words, an unhappy corporation.

Nevertheless, approaching the question from the standpoint of the Treasury Department, it seemed obvious in 1976 that R&D findings derived from U.S. corporate expenditures might well be exploited abroad by foreign sister or subsidiary corporations. The R&D findings might have been transferred on a royalty-free basis (perhaps as a contribution of capital) or they might have been licensed for a royalty. Whatever the mode of transfer, if there was some use abroad of R&D findings generated in the United States, the statutory language of Section 861 seemingly compelled the Treasury Department to attribute some R&D expense to foreign source income.

In a world of tax harmony, if certain R&D expenses are attributed by the U.S. to foreign source income, those same expenses should also be recognized by the foreign country as a deduction against income. As a deduction, they should serve to reduce foreign income taxes. But we do not live in a world of tax harmony.

Through a long process of negotiating tax treaties, the industrial countries have reached broad agreement on the boundaries that separate gross income earned in one country from gross income earned in another country from gross income earned in another country. Much less agreement has been reached on the proper attribution of expenses. In particular, there is very little agreement as to whether R&D expenses incurred in one country may be attributed to gross income earned in another country. Moreover, as between the industrial countries and the developing countries, there are still substantial disagreements as to which items of gross income are properly sourced in each country.

If countries could reach agreement on proper income source rules and expenses attribution rules, then no item of income would be claimed as domestic source income by more than one country, and each item of corporate expense would reduce taxable income someplace in the world. But in today's imperfect world, many nations simply disallow, as a deductible expense of the corporate taxpayer, any money spent on R&D work performed outside the national boundaries. Moreover, some countries disallow a deduction for royalty payments made by a domestic corporation to a foreign sister or parent corporation; and many countries impose high withholding taxes (15 percent and more) on royalty payments made to foreigners. In the absence of a Section 861 allocation, these various restrictive practices would serve to deny the U.S. Treasury much chance of recouping any tax revenue from income earned on the exploitation abroad of research conducted in the United States.

In the face of these attitudes, the U.S. has two basic policy choices:

(1) The U.S. can decide that some portion of R&D expense should be attributed to the corporation's foreign source gross income, no matter whether foreign countries will allow a deduction for all or part of the attributed expense;

Or:

(2) The U.S. can decide that, both to encourage R&D activity in the U.S. and to remove a cause of tax disharmony with foreign countries, the U.S. will attribute all R&D expense incurred domestically to U.S. source income, regardless whether some of the R&D findings are used overseas.

In 1920, or thereabouts, Congress chose the first policy when it enacted Section 861. In 1981, Congress chose the second policy when it enacted Section 223(b) of the Economic Recovery Tax Act.

The language used by Congress in 1920 to carry out its policy was rather general, and probably took no more than a day or two to draft. When it came time, some 45 years later, to give that language concrete meaning, it took 12 years to reach a set of final regulations. Why was the task so difficult? It was difficult because there are no clear cause-and-effect accounting rules for linking R&D expense incurred by one corporation, in one country, at one point in time, to income earned by another corporation, in a different country, at a different point in time.

In the face of this difficulty, why didn't the Treasury leave well enough alone? The reason was that the day-to-day administration of the Section 861 rules was rapidly approaching chaos. Different corporations and different revenue agents were developing their own allocation theories. In time, these conflicting theories would have been litigated in the Tax Court, in the District Courts, in the Court of Claims, and in the Circuit Courts. The foreseeable result? A patchwork of conflicting decisions that would have taken decades to emerge and more decades to sort out.

The details—and some of the drama—of the debate that raged in the Treasury halls in 1976 are captured in six memoranda that I have attached to this statement.

(The memoranda are dated April 26, 1976; October 9, 1976 [two items]; October 13, 1976; October 20, 1976; and December 21, 1976.) Those memoranda and subsequent events make clear:

The IRS believed, almost to the last, that R&D expense should be apportioned on the basis of domestic and foreign sales of the corporate group, and that any deviation from a "sales-to-sales" approach represented a "giveaway" to multinationals.

The Commerce Department believed that little or no R&D expense should be allocated to foreign source income, on the theory that any allocation would cause research activity to migrate overseas.

In the final draft, we at the Treasury thought we had accepted every plausible argument for assigning a disproportionate part of R&D expense to U.S. source income, both because we wanted to minimize any tax migration of research activity, and because we wanted to stake out a position that stood some chance of eventual acceptance by foreign tax authorities.

Only because of the dogged perserverance of Assistant Secretary Walker and Secretary Simon were regulations issued in the closing days of the Ford Administration.

In 1976, the Treasury estimated that the R&D part of the regulations might increase U.S. tax collections by \$350 million at most. (By contrast, the 1973 version of the regulations, favored by the IRS, might have increased tax payments by upwards of \$1.0 billion.) As it turned out, the regulations finally adopted, if they had been in effect in 1982, would have increased taxes by \$100-\$240 million.

We recognized that the allocation rules would need to be evaluated in light of subsequent experience. The Treasury's recent study, *The Impact of the Section 861-8 Regulations on U.S. Research and Development*, performs that evaluation in a clear and thorough manner.

As Congress considers extending, or making permanent, the 1981 ERTA moratorium on Section 861 as applied to R&D expense, it seems to me that two sets of questions deserve consideration.

First, what are the respective roles of (a) the Section 861 allocation rules, and (b) the 25 percent tax credit for incremental R&D expense, in encouraging U.S. Corporations to perform a larger total level of R&D activity and to perform a larger share of that activity within the United States? Does the United States need two tax tools—namely the incremental R&D credit and the Section 861 moratorium—to accomplish the commendable result of stimulating private research activity?

Second, wouldn't the world be better off if tax authorities in each country recognized some portion of R&D expense incurred abroad as a legitimate corporate deduction? Conversely, if this sort of recognition cannot be accomplished, isn't the next step for the U.S. to disallow—for purposes of computing U.S. source taxable income—R&D expenses incurred abroad? But doesn't that sort of retaliation amount to "tax protectionism"—namely using the tax system to protect economic activity performed at home and to discriminate against activity performed abroad? And isn't tax protectionism inconsistent with the basic U.S. commitment to a liberal world trading order?¹

With these kinds of questions in mind, Congress might eventually decide to require some allocation of domestic R&D expense to foreign source income. However, if and when it takes that step, Congress might simultaneously give the Treasury discretionary authority to disallow—as a deduction for computing U.S. taxable income—selected expenses incurred in those individual foreign countries that refuse to give appropriate recognition to R&D expense incurred in the United States. Armed with this stick, the goals of Section 861 might ultimately be accomplished.

Thank you, Mr. Chairman, for this opportunity to review a page of tax history.

¹ I hasten to note that tax protectionism is becoming all too common with the advent of tax credits, such as the investment tax credit, that are limited to expenditures in the home country, even when investment expenditures abroad may produce domestic source gross income.

ATTACHMENT 1

OPTIONAL FORM NO. 10
MAY 1962 EDITION
GSA FPMR (41 CFR) 101-11.6

UNITED STATES GOVERNMENT

Memorandum

Hufbauer

Department of the Treasury
Washington, D.C. 20220

TO : Assistant Secretary Walker

DATE: April 26, 1976

FROM : Robert Patrick, Gary Hufbauer, George Carlson,
John Raedel

SUBJECT: Proposed Regulations under Section 861 on Allocation and
Apportionment of Deductions

INTRODUCTION

The Internal Revenue Code in sections 861(b) and 862(h) provides that, for purposes of determining the taxable income from sources within the United States and from sources without the United States, there shall be deducted from the gross income from each source the expenses, losses and other deductions (hereinafter collectively referred to as deductions) which are properly apportioned and allocated thereto and a ratable part of those deductions which cannot be definitely allocated to some item or class of gross income.

While these statutory provisions have been in effect since 1920, they have been supplemented only with brief regulations that offer little guidance for either taxpayers or revenue agents as to how the law should be applied.

In June of 1973, the Treasury Department issued Proposed Regulation section 1.861-8 which set forth detailed rules for the allocation and apportionment of deductions to gross income. Substantial public comment and criticism ensued. Many U.S. companies strongly argued that the proposed regulation will substantially increase their total (domestic and foreign) tax payments. The crux of their concern is that the required allocation and apportionment will reduce their foreign source income for U.S. tax credit purposes and hence lower their allowable foreign tax credit without any corresponding reduction in foreign taxes, since foreign countries will not necessarily agree to the U.S. allocation and apportionment of deductions.

The Office of International Tax Affairs has estimated that under the present proposed regulation, the allocation of R&D expenses to foreign source income would increase U.S. tax revenue between \$1.1 and \$1.5 billion annually. The allocation of other types of expense would exert a considerably smaller, but in some cases still significant, impact on revenues.

The remainder of this memorandum identifies the major issues that have been raised with respect to Proposed Regulation section 1.861-8 and offers recommendations for their disposition.



5010-108

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ISSUES

1. What is meant by an allocation and apportionment of a "ratable part" of deductions not definitely related to any item or class of income?

Analysis

Under present practice, which has been endorsed by the courts, deductions which are not definitely related to any item or class of gross income are allocated and apportioned on the basis of gross income from domestic and foreign sources. It is thus argued by some, not unpersuasively, that prior practice and judicial precedent require that the "ratable part" language of the statute be read to mean that deductions not definitely related to any item or class of income be allocated and apportioned using the so-called "gross-to-gross method, that is, on the basis of gross income from U.S. and foreign sources. However, the gross-to-gross method has been criticized because the types of gross income earned from U.S. sources are often very different than the types of gross income earned from foreign sources. Gross income from U.S. sources is predominantly business receipts less cost of goods sold; gross income from foreign sources is predominantly dividends, interest, rents, and royalties, since most U.S. firms operate abroad through foreign corporate subsidiaries. ^{1/}

With limited exceptions, this "gross-to-gross" method is not applied in Proposed Regulation section 1.861-8. ^{2/} In its place this regulation introduces the concept that all deductions not definitely related to a specific item or class of income are definitely related to all income as a class. Using this device few, if any, deductions are not definitely related to any class of income. Accordingly, the regulation takes the position that in almost all cases there is no need to reach a "ratable part" determination and hence, the gross-to-gross method is generally inapplicable to the allocation and apportionment of deductions. Rather, the regulation requires that deductions allocated to all income as a class are to be apportioned, either (1) under specific rules set out in the regulation, e.g. the interest rules, or (2) if not specifically dealt with on some reasonable basis. Such basis include the relative amounts of units sold, gross sales, costs of goods sold, profit contributions, assets used, space utilized, etc.

^{1/} If foreign corporate subsidiaries were required to file a consolidated return with the U.S. parent corporation, the disparity in types of gross income would no longer exist.

^{2/} These exceptions, listed in Prop. Reg. section 1.861-8(e)(9) are: interest allowed only by section 163, real estate or sales taxes incurred with respect to items for personal use, charitable contributions, alimony, and certain shareholder expenses, e.g., cost of issuing an annual report.

Thus, to the extent that the "ratable part" language of Code sections 861(b) and 862(b) can be interpreted in the courts to require an allocation and apportionment under the gross-to-gross method, the Proposed Regulation, in substance, appears to have read that language out of the statute.

Since there exists the strong possibility that taxpayers may succeed in having the courts hold the Proposed Regulation invalid on the ground that it does not properly reflect the intent of the statute, i.e., that it gives effect to the "ratable part" language only in limited and inconsequential situations, an alternative general approach to the allocation and apportionment of deductions which reaches essentially the same substantive result may be desirable.

Recommendation

That the regulation provide for the allocation and apportionment of deductions within the following broad framework:

1. deductions which are definitely related to an item or class of income should be allocated to that item or class of income.
2. deductions which are not definitely related to any item or class of income should be allocated and apportioned on a ratable basis which:
 - a. in the case of certain enumerated deductions, e.g. interest, R & D, stewardship expenses, etc. shall be as described in the present Proposed Regulation or some variation thereof; and
 - b. in all other cases on some reasonable basis which may include the "gross-to-gross" method.

Agree _____

Disagree _____

2. Should allocation be required for administrative expenses of a "stewardship" nature?

Analysis

Expenses incurred to provide specific services (such as market research) for the direct benefit of a related corporation are allocable to the fee received for such services. "Stewardship" expenses are different in that they duplicate functions performed by the subsidiary's own employees. For example, a parent corporation may, for its own

benefit, audit the books of a subsidiary, although the subsidiary has its own accounting personnel who also perform this work. Since such "stewardship" or "overseeing" functions are incurred as a result of an ownership interest in the related corporation, it is reasonable that some portion of the expenses incurred be allocated to the income received from the related corporation and apportioned on a basis that properly reflects the extent of the "stewardship" activities.

The Proposed Regulation, however, does not clearly delineate the extent to which such "stewardship" expenses include or exclude all items of general corporate overhead.

Recommendation

The regulations should require the allocation and apportionment of "stewardship" expenses and should more clearly define the type of expenses included in this category.

Agree _____ Disagree _____

3. How should the interest expense of non-financial corporations be treated?

Analysis

The Proposed Regulation takes the approach that money is fungible. Regardless of the specific purpose for which the money was nominally borrowed, the debt can be used to support a general expansion in a taxpayer's income-producing assets. Accordingly, under the Proposed Regulation, interest expense is allocable to all income and should be apportioned on the basis of assets used in income-producing activities.

Taxpayers have argued that this approach, rather than more clearly reflecting the proper allocation and apportionment of interest expense tends to distort the allocation because: (a) the use made of current borrowings may not bear a very precise relationship to the use made of past borrowings; and (b) the interest expense incurred by foreign subsidiaries is not considered under the Proposed Regulation.

An incremental approach has been suggested as a solution to the first of these problems. Such an approach would not allocate and apportion interest expense on past borrowings, while interest incurred on new obligations would be allocated on the basis of increases in the taxpayer's assets, rather than on the basis of total assets. Thus, if an obligation were incurred during the taxable year and only the level of domestic assets increased during that year, the interest expense on such an obligation would be allocated entirely to U.S. source income.

The argument favoring the incremental approach assumes that to achieve a proper allocation of interest expense, the allocation method should reflect the use made of the borrowed funds. However, if the fungibility of money theory underlying the interest allocation method in the Proposed Regulation is accepted, the specific use made of past or present borrowings is generally irrelevant. In such case it is the incremental approach which results in an improper allocation of interest expense. Moreover, an incremental allocation method would result in added complexity for both the taxpayer and the Service. Finally, it should be noted that there already is a provision in the Proposed Regulation permitting the allocation of interest to the income from specific property if a series of tests can be met.

The second problem raised with the interest allocation rules in the Proposed Regulation is that they do not recognize interest payments made by foreign subsidiaries, and hence tend to overstate the interest to be allocated to foreign source income. In this case, the theory of fungibility suggests that such expenses should be reflected in the allocation and apportionment process.

Accordingly, a limited "two-way fungibility" approach might be adopted which would allocate domestically incurred interest expense to foreign source income on the basis of total assets, but only to the extent that foreign assets do not already bear a proportionate share of worldwide interest expense as a result of foreign borrowings.

Such an approach would involve consolidation of the interest payments made to unrelated creditors of the domestic corporation and its controlled foreign corporations. The total interest expense would then be apportioned on the basis of total assets. Interest payments made by CFCs would then be subtracted from their share of total interest expense in order to compute the allocation of U.S. interest expense to foreign income. Two-way fungibility would be limited in that the interest expense of the CFC could not "spill over" and be claimed as a deduction by the parent firm.

Recommendation (a)

The regulations should require allocation and apportionment on the basis of total assets, rather than on the basis of increments to the total.

Agree _____ Disagree _____

Recommendation (b)

The regulations should apply a limited two-way fungibility approach. The interest expense of controlled foreign corporations should be consolidated with those of the parent corporation for purposes of allocating the parent's interest expense.

Agree _____ Disagree _____

4. How should the interest expense of financial institutions be treated?

Analysis

The proposed regulations reserve the treatment of interest expense incurred by financial institutions. The Service is considering alternative theories, not involving fungibility, as a basis for allocating their interest expense. But the fungibility theory applies best to financial institutions that can shift assets with great flexibility from country to country. It seems reasonable to apply the same rules to financial institutions as to other taxpayers.

Recommendation

The regulations should apply the same rules for allocating the interest expense of financial institutions as are applied to the interest expense of other taxpayers.

Agree _____ Disagree _____

5. Should the allocation of losses on the sale, exchange or other disposition of property be determined under the principles of the present source rules?

Analysis

The Proposed Regulation provides that losses on the sale, exchange or other disposition of assets are to be allocated to the classes of gross income to which such assets normally give rise. Thus a loss incurred on the sale of a machine in Germany which was used there to manufacture bolts would be allocated to both U.S. and foreign bolt-manufacturing income. If the same machine were sold at a gain, the income would be entirely classified as income from foreign sources by virtue of Code section 862(a)(6). That section provides that the source of gain on the sale of personal property is where title passes, which in this case would be Germany.

In order to avoid this disparate treatment with respect to gains and losses on the sale of assets, it has been suggested that the allocation of losses should follow the same rules as are applied in the case of gains.

Recommendation

The allocation of losses on the sale, exchange, or other disposition of property should be determined under the same source rules as are applied to gains from such transactions.

Agree _____ Disagree _____

6. What is the class of gross income to which research and development expenditures should be allocated?

Analysis

The proposed Regulation allocates R&D expenses which are not "definitely related" to a specific item or class of income to all classes of income likely to benefit from such expenses. The enumerated classes of income likely to benefit from R&D expenses include: sales, rentals, lump-sum sales of intangible property, licenses and dividends. Many of these types of income, however, do not predominately result from R&D expenses. Thus, the objective underlying the Proposed Regulation of achieving an allocation based on the close identification between deductions and the income such deductions generate would be severely undermined where, for example, R&D expenses are allocated in part to foreign source dividends or even license income from the use of a trade name. Rather, the Proposed Regulation should require that R&D expenditures be allocated only to items of foreign income which predominately result from such expenses--specifically, foreign source royalty income and income from sales of technology.

In order to justify limiting the allocation of R&D expenses to foreign source royalty income, the U.S. parent corporation must be compensated on an arm's length basis for all technology transfers to foreign users. Accordingly, foreign royalty payments should meet the standards set forth in Code section 482 and Regulation section 1.482-2(d), and the present ability to transfer patents and know-how tax-free to foreign manufacturing subsidiaries should be eliminated. This change would require as a minimum new regulations under Code section 367. 1/

Recommendation

All transfers of technology to foreign users should be made taxable. R&D expenses should be allocated only to foreign source royalty and other technology transfer income.

Agree _____ Disagree _____

7. How should R&D expenses be apportioned between U.S. and foreign source income?

Analysis

Assuming that all technology transfers are made taxable and that R&D expenses are made allocable only to royalty and other technology transfer income, it is necessary to devise an administratively feasible method for the apportionment of such expenses between domestic and foreign sources.

1/ It should be noted that the existing rules under Code sections 351 and 367 would not be changed for transfers of other types of property.

A theoretically proper apportionment method for R&D expenses would apportion such expenses to foreign source income on the basis of the ratio between foreign source royalty income and total royalty income and would reflect, in some manner, the mismatch of revenue and expense arising from the lag between the time when R&D expenses are incurred and the time when the income such expenses generate is received.

Unfortunately, creation of such a theoretically proper apportionment method leads to a complex and unwieldy mechanism. For example, since most companies which incur R&D expense do not domestically license the technology developed, but rather use it in their own production, they would be required to "construct" a domestic royalty for use in the apportionment formula. Such a "constructive royalty" would be based on a number of variable factors and subjective judgments, all of which would be subject to dispute on audit by the IRS. Moreover, any attempt to take account of the impact of the time lag effect on the allocation and apportionment of R&D expenses, (e.g., by providing for a capitalization and amortization election) would lead to additional complexity, and might require additional legislation.

On the other hand, while a theoretically proper apportionment method may be difficult to administer, a reasonably simple apportionment method, such as the one in the Proposed Regulation may create undesirable results.

The apportionment method set forth in the Proposed Regulation generally provides for the apportionment of R&D expenses between domestic and foreign sources on the basis of units of production or gross sales determined on a consolidated basis. Such an apportionment method alone, however, does not take into account the fact that R&D expenditures may be more valuable in the United States than abroad, nor does it reflect the lag which exists between the time an expenditure for R&D is incurred and the time the revenue such an expenditure generates is received. Moreover, if all transfers of technology abroad are made taxable, such an apportionment method would fail to reflect the value added abroad by R&D expenditures which have already been "recaptured" for U.S. tax purposes. Cumulatively, these defects in the Proposed Regulation's apportionment method tend to apportion too much R&D expense to foreign source income.

One approach which has been suggested for an administratively feasible apportionment method that mitigates to some extent the defects of the Proposed Regulation is based on the assumption that over time R&D expenditures will ordinarily produce a profit. Under this approach, the total of foreign source royalty and other technology transfer income determined on an arm's length basis less an assumed profit of, say, ten

percent is made the upper limit for the apportionment of R&D expense in any year. Actual R&D expense is first apportioned between domestic and foreign sources on the basis of gross sales determined on a consolidated basis. If the R&D expense apportioned to foreign sources is less than ninety percent of the foreign source royalty and related income, then the expense so apportioned shall stand. But if the R&D expense apportioned to foreign sources exceeds ninety percent of the foreign source royalty and related income then the latter amount shall stand as the limit on the apportioned expense. Thus, the allocation and apportionment of R&D expense will be permitted to offset up to ninety percent of a company's foreign source royalty and other technology transfer income, but will not be permitted to spill-over to reduce any other foreign source income.

Further analysis, however, is required to support an appropriate profit percentage. In determining the appropriate profit percentage, consideration should be given to the existing methods used to repatriate research licensing profits in forms other than as royalty income, the value implicit in receiving a current profit on expenses which may not actually generate a profit until a future year, and the rates at which other countries withhold taxes on royalty payments to U.S. recipients.

Moreover, it will be necessary to resolve certain questions which arose in discussions with various industry groups of the allocation and apportionment method proposed in this paragraph and paragraph 6. Among the questions remaining to be resolved are: (1) the degree to which technology transfers will be difficult to value; (2) the impact these proposed rules will have on the present practice of capitalizing foreign joint ventures with tax-free contributions of technology; (3) the allocation and apportionment method to be applied in cases where a foreign country actually or effectively blocks any royalty payments; and (4) the treatment of cost sharing and cross licensing arrangements under these proposed rules. We do not believe any of these matters present insurmountable problems.

While the approach outlined in paragraphs 6 and 7 is not perfect, it does prevent the excessive apportionment of R&D expense to foreign source income possible under the Proposed Regulation while at the same time providing a reasonably simple and administrable means of apportionment.

Recommendation

The foreign source royalty and other technology transfer income less an assumed profit should be made the upper limit to the apportionment of R&D expenses and such expenses should be apportioned up to that limit on the basis of the ratio of foreign to total gross sales determined on a consolidated basis.

Agree _____

Disagree _____

8. Should the regulations, when implemented, apply prospectively or retroactively?

Analysis

Good arguments can be made for either approach. Since the final regulations may represent a significant departure from present practices, it can be argued that they should only apply prospectively in order to minimize undue hardships and permit taxpayers to accommodate their activities and records to the new requirements. Particularly difficult areas involve the allocation of past year interest expense and the allocation of R&D expense under the method proposed above. On the other hand, if the regulations are not made retroactive, taxpayers and the Service will have no guidance for the allocation of deductions during open tax years. Moreover, it can be argued that the regulations are, for the most part, merely an amplification of existing statutory requirements. They reflect allocations which taxpayers should have been making all along. Therefore, making their application retroactive would treat all taxpayers equally; and those taxpayers who have been making correct allocations would not be penalized.

Recommendations

The regulations should apply retroactively. *prospective*

Agree _____ Disagree _____

However, because of the special equity problem involved in requiring the allocation of past year interest expenses and in requiring taxable technology transfers and allocation of R&D expense in a significantly different manner, the regulations should apply only to interest paid, and R&D expenses incurred, after the date the regulations become effective.

Agree _____ Disagree _____

9. Who should initially redraft the proposed regulations to conform to these decisions: Treasury or IRS?

Analysis

Usually the IRS drafts regulations and sends them to the Treasury for comment. It might be argued that in view of the long delays, the obscure language and conceptual confusion in the proposed regulations, and the entrenched opposition of technical personnel at the Service to any change, it would be better for Treasury to prepare an initial draft prior to opening discussions with the Service.

On the other hand, if the Treasury prepares the initial revised draft, we will fail to use the drafting skills and experience which are peculiar to the IRS, the initial drafting may take a longer time because Treasury personnel are pressed with many responsibilities, in addition to the drafting of regulations, and the intransigence of certain IRS personnel to a change in the regulations may be more difficult to overcome if the revision is not their own. Most importantly, if Treasury prepares the initial draft we might lose the ability to review the regulation in an objective fashion.

Recommendation

Treasury and the IRS should discuss and reach agreement with respect to the nature and general form of all modifications to the Proposed Regulation. The IRS then should prepare an initial revised draft of the regulation within a reasonably short period of time, perhaps no longer than four weeks. However, if agreement is reached with the IRS and they do not produce a revised regulation within this time period, then Treasury should proceed to draft the revised regulation.

Agree _____

Disagree _____

ATTACHMENT 2

Date: 9 Oct. 1976

MEMORANDUM FOR: SECRETARY SIMON

From: Gary Hufbauer GH

Subject: Section 861 Regulations

Attached is a new version of the memorandum summarizing the Treasury and IRS positions. Certain changes in the previous version were requested by Commissioner Alexander.

Handwritten: 10/11/76
 10/11/76
 10/11/76

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname						
Initials / Date						

Date: OCT 9 1976

MEMORANDUM FOR: SECRETARY SIMON

From: Charles M. Walker CMW by GCH
 Assistant Secretary for Tax Policy

Subject: IRS and Treasury Drafts of Proposed Regulations under
 Section 861: Allocation and Apportionment of Expenses

I. History and Introduction

The Internal Revenue Code in sections 861(b) and 862(b) provides that, for purposes of determining a taxpayer's taxable income from sources within the United States and from sources outside the United States, there shall be deducted from the gross income from each source the expenses, losses, and other deductions which are properly apportioned and allocated thereto and a ratable part of those deductions which cannot be definitely allocated to some item or class of gross income. The issue for U.S. companies under these sections is not whether certain expenses are deductible, but rather how deductible expenses are to be divided between gross income from domestic and foreign sources.

While these statutory provisions have been in effect since 1920, they have been supplemented only with brief regulations that offer little guidance for either taxpayers or revenue agents. More detailed regulations were first proposed in 1965, soon withdrawn, reissued in 1966, and again withdrawn. In June 1973, the Treasury Department issued Proposed Regulation 1.861-8 which set forth detailed rules for the allocation and apportionment of deductions to gross income. Substantial public criticism ensued. The crux of the concern voiced by affected taxpayers and by the Task Force of the Economic Policy Board is that the required allocation of deductions to foreign source income would reduce taxable foreign source income for U.S. tax credit purposes and thus reduce the allowable foreign tax credit, without a corresponding reduction in foreign taxes unless under competent authority provisions or treaty negotiations reductions are achieved.

In numerous meeting and drafting sessions, extending over a period of many months, staff personnel from the

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec
Surname	Carlson	Raedel	Hufbauer			
Initials / Date	GC / 10/17/76	JR / 10/17/76	GCH / 10/19/76	/	/	/

Treasury Department and the Internal Revenue Service have sought to recognize the legitimate concerns of taxpayers by extensively revising the 1973 Proposed Regulation. The Treasury and IRS, at a Policy Committee meeting, tentatively agreed on the modifications (for interest and research and development) which are labeled as the IRS modifications in this memorandum. Subsequently, some Treasury officials discussed these modifications with the Task Force of the Economic Policy Board and with industry representatives, and these modifications were stated to be unacceptable to both groups. These Treasury officials further considered the key issues and developed the Treasury modifications set forth in this memorandum. While the two staffs have reached agreement on many points, such as the appropriate treatment of losses, stewardship expenses, legal and accounting fees, and state and local income taxes, significant disagreement remains on what other modifications should be made in the 1973 Proposed Regulation. This disagreement centers on two types of expense: interest expense and R&D expense. This memorandum identifies the major problems taxpayers have raised with respect to the 1973 Proposed Regulation, describes the different solutions to these problems that the Treasury and Internal Revenue Service are urging, and provides rough quantitative estimates on the likely impact of the 1973 Proposed Regulations and the suggested modifications.

II. Interest Expense

1. 1973 Proposed Regulation

The Proposed Regulation adopts the approach that money is fungible. Regardless of the specific purpose for which money was nominally borrowed, it can be used to support a general expansion in a taxpayer's income-producing assets. Accordingly, under the Proposed Regulation, a taxpayer's interest expense is allocable to all income and apportioned on the basis of the book or market value of the relative amounts of the taxpayer's domestic and foreign assets.

2. Taxpayers' Objections

Taxpayers contend that the Proposed Regulation would apportion too much domestic interest expense to foreign source income because it gives no recognition to the interest expense or liabilities incurred by foreign subsidiaries of U.S. corporations.

3. Treasury Modifications

(i) Description. Both the Treasury and the Internal Revenue Service recognize that the theory of fungibility leads to consideration of the interest expense and the

liabilities of foreign subsidiaries. But it also leads to consideration of the interest expense and the liabilities of domestic subsidiaries. Numerous attempts to draft rules that "looked beyond" the immediate taxpayer floundered in a sea of complexity and statutory contradictions, and the approach was abandoned.

Because some modification of the Proposed Regulation is justified, the Treasury urges that a taxpayer be allowed to apportion interest expense either under the asset method of the Proposed Regulation or under a gross income method. Under the gross income method, the taxpayer may elect to apportion interest expense on the basis of gross income from foreign and domestic sources, if the apportionment to foreign sources is not less than 50 percent of the amount of interest expense that would be apportioned on the basis of assets. To remove a "notch", if the apportionment of interest expense to foreign source income on the basis of amounts of gross income is less than 50 percent of the apportionment on the basis of assets, the taxpayer may apportion to foreign sources exactly 50 percent of the interest expense that would have been apportioned on the basis of assets to foreign sources.

(ii) Analysis. The Treasury believes that the gross income option is a reasonable, although imperfect, response to the shortcomings and hardships resulting from an apportionment based strictly on asset values. Moreover, since both the assets and gross income options have shortcomings, Treasury believes that it is appropriate to remove the "notch" in order to avoid the inequitable result of forcing a taxpayer to use the assets method when a gross income method would apportion only 49 percent, rather than 50 percent, of the amount of his interest expense apportionable to foreign sources under the asset method.

4. Internal Revenue Service Modifications

(i) Description. The Internal Revenue Service also believes that the taxpayer should be permitted to apportion his interest expense on the basis of either the asset approach of the 1973 Proposed Regulation or, with one critical difference, on the basis of the gross income option outlined above. The difference is that the Internal Revenue Service is opposed to eliminating the "notch". Under the Internal Revenue Service approach, a taxpayer who could only apportion 49 percent, rather than 50 percent, of his interest expense to foreign sources under the gross income option would be required to use the assets method.

(ii) Analysis. The Internal Revenue Service believes that the gross income option should be provided only as a "safe-haven" for those cases where apportionment on the basis of gross income yields substantially the same result as apportionment on the basis of assets. The Internal Revenue Service favors apportionment on an assets basis because of the differing earning capacity of assets and the opportunity available to U.S. corporations to retain earnings in their foreign subsidiaries. The IRS believes that asset values are more closely related to interest expense than is the receipt of income in any given year. While the IRS was willing to accept the "safe-haven" at the 50 percent level, it did consider this percentage to be very liberal and suggests that the severity of the "notch" is, in fact, due to the liberality of this safe-haven percentage. Thus, removal of the notch would represent a significant extension of an already liberal "safe-haven" rule. If a taxpayer is well below the 50 percent criterion under the gross income method, this is clear evidence that:

- (1) asset apportionment gives a more correct result; and
- (2) the taxpayer is not entitled to a "safe-haven."

5. Options

- (i) Treasury recommendation of gross income option without "notch" _____.
- (ii) IRS recommendation of gross income option with "notch" _____.

III. Research and Development Expense

1. 1973 Proposed Regulation

The Proposed Regulation allocates R&D expense to all income likely to benefit from the expense, such as income from sales of goods, rentals, lump-sum sales of intangible property, licenses and dividends. Once allocated, the R&D expense is then divided between income from domestic and foreign sources on the basis of relative amounts of units of production sold or the value of sales.

2. Taxpayers' Objections

Taxpayers contend that these rules apportion too much R&D expense to foreign source income. They argue that an apportionment based solely on relative amounts of sales ignores the following important factors: R&D is applied in the foreign market only after it first has been exploited in the domestic market; because of this lag in foreign application, R&D has a lower value per unit of sales when used in foreign markets; R&D benefits many products at home, but only a fraction of these are produced and sold in foreign markets; and R&D performed today may not generate income until many years in the future. Taxpayers argue that these factors can be simply summarized: R&D performed in the United States is more valuable here than it is abroad. Accordingly, a division of R&D expense based solely on relative amounts of sales apportions far too much R&D expense against foreign source income and far too little against domestic source income.

3. Treasury Modifications

(i) Description. The Treasury urges that these criticisms be met by modifying the apportionment based on sales and by also providing an optional apportionment on the basis of gross income.

(A) Sales option. A taxpayer using the revised sales method would follow these four sequential steps.

1. R&D is identified by broad product category. Thus, sales of machinery at home and abroad would not be taken into account for purposes of allocating and apportioning R&D on pharmaceuticals.

2. A taxpayer's R&D expense which is undertaken solely to meet health, safety, and pollution standards imposed by the U.S. Federal, state or local governments is allocated solely against domestic source income.

3. Recognizing that R&D is more valuable at home than abroad, the revised sales method permits a taxpayer to exclusively apportion a certain percentage of the remaining R&D expense to domestic source income. The percentage is set at 50 percent in 1977, 40 percent in 1978, and 30 percent in 1979. For years after 1979, the percentage will be set on the basis of the results of a Treasury-IRS study. If the exclusive apportionment provided by the regulation is not adequate for a particular taxpayer's facts and circumstances, the taxpayer may attempt to establish a higher alternative percentage.

4. The remaining R&D expense (after the allocation for government-mandated research and the exclusive apportionment to domestic source income) is apportioned between domestic and foreign sources on the basis of relative values of sales.

(B) Gross Income Option. As an alternative to the sales method, the taxpayer may elect to apportion research and development expense on the basis of gross income, if the apportionment to foreign sources is not less than 50 percent of the amount which would be apportioned under the sales method outlined above. Again, to remove the "notch", if the amount of R&D expense apportioned under the gross income method is less than 50 percent of the amount apportioned under the sales method (with the 50-40-30 percent exclusive apportionment), then exactly 50 percent of the apportionment made on the basis of sales may be apportioned to foreign sources.

(ii) Analysis

The Treasury believes that the sales and gross income options, taken together, represent a fair and reasonable recognition, both of taxpayers' legitimate concerns that the Proposed Regulation allocates too much R&D expense to foreign source income and of the difficulties inherent in making a proper allocation of R&D expense. Moreover, since the imprecision of allocation under the R&D rules is similar to that under the interest rules, the Treasury believes it reasonable to provide a parallel gross income option for R&D expenses.

4. Internal Revenue Service Modifications

(1) Description.

The Internal Revenue Service agrees with the four-step sales method outlined above. The Internal Revenue Service is strongly opposed, however, to a gross income option in the R&D area.

(11) Analysis.

The Internal Revenue Service believes that the four-step sales approach is an exceedingly liberal departure from the 1973 Proposed Regulation and meets all reasonable objections raised by taxpayers. Accordingly, in the IRS view, a gross income option constitutes a "bargain basement" concession to large multinational corporations. The IRS has opposed the gross income method as representing a distortion of the apportionment process for determining foreign source taxable income because, generally speaking, gross income received from the U.S. and abroad, respectively, are of significantly different types. Gross income from the U.S. is most often sales or service income and gross income from abroad is generally made up of royalties, technical fees, and dividends. Thus, the IRS favors the sales method as providing superior comparability of foreign with domestic factors.

5. Options

(1) Treasury recommendation for the sales method with a gross income optional method.

(11) IRS recommendation for the sales method without a gross income optional method.

IV. Economic Impact of Proposed Regulations

The impact of the 1973 Proposed Regulation or any modification thereto depends on the extent to which it would increase the tax liabilities of U.S. firms.

A Commerce Department study of the R&D aspects provides some indication of these effects. Of course the industry answers must be discounted somewhat because of self-interest.

1. Present allocation practices. The present allocation practices vary substantially from company to company. Many companies make no allocation of R&D expense to foreign income. Some companies allocated R&D expense on a "gross-to-gross" basis (gross income from domestic sources vs. gross income from foreign sources), but no uniform definition of gross income is applied. Some firms make absolutely no apportionment of interest or R&D expense to foreign income.

2. Impact of the Proposed Regulation on tax payments. Firms in the Commerce Department study responded that, on average, the 1973 Proposed Regulation would increase their taxes by about 10 percent of their R&D expenditures, or by about \$1.2 billion. This is within the range of the Treasury Department estimate of \$1.1 billion to \$1.5 billion. Based on these figures, the Treasury Department estimates that the modifications acceptable to the Internal Revenue Service would reduce the tax impact to \$300 million to \$700 million and that the tax impact of the Treasury Department modifications probably would not exceed \$350 million and might be somewhat less.

The tax impact of the interest rule is less certain. Under the Proposed Regulation it would probably be about \$350 million; under either the Treasury Department or Internal Revenue Service modifications it could range between zero and \$100 million, but the amount would be somewhat less under the Treasury Department approach.

3. Movement of R&D overseas. Of the 59 firms responding in the Commerce Department study, 30 said that implementation of the Proposed Regulation would possibly cause them to move R&D abroad, and 12 said that the amounts of R&D moved abroad could over time be substantial. As a practical matter, the wholesale shift of a large firm's R&D facilities from the United States to a foreign location would be difficult, and in some foreign countries risky. It is unlikely that an average increase in the cost of R&D of 10 percent would prompt a sudden and major relocation of facilities; and even less likely if the increase is 5 percent or 3 percent as it would be under the Internal Revenue Service or Treasury Department modifications. However, some U.S. firms might expand their R&D facilities abroad at a differentially faster rate than in the United States.

4. Reduction of R&D budgets. The answers in the Commerce Department study concerning potential reduction of R&D budgets in response to the Proposed Regulation were mixed. Out of 59 respondents, 4 said they expected total R&D budgets to be reduced, and 5 said such reductions were possible. Others said a reduction would take place if it did not prove feasible to move R&D abroad. Of course, these reductions, if accurate, would be moderated by the Internal Revenue Service or Treasury modifications.

V. Conclusion

1. Summary

Regulations interpreting Section 861 have been discussed for a decade. The turnover of senior personnel in Treasury and IRS almost ensures that expertise is lost each time this complex subject is mastered by a fresh generation of policy makers. The delay has caused uncertainty and has spawned a bewildering variety of administrative practices. The Treasury and Internal Revenue Service strongly believe that the time has come to resolve these issues. The alternative positions of the Treasury and Internal Revenue Service described in this memorandum are forwarded to you with the recommendation that you choose between them and that a re-proposed regulation be issued as soon as practicable.

2. Options

- (i) Issue new proposed regulations as soon as practicable _____
- (ii) Delay action until a later date _____

ATTACHMENT 3

Date: October 9, 1976

MEMORANDUM FOR: SECRETARY SIMON

From: Donald C. Alexander /s/ D. A.
 Commissioner of Internal Revenue

Subject: Proposed Regulations under Section 861

I am writing this separate memorandum reluctantly only because I am convinced that the option memorandum does not present the issue fairly.

1. First, we are talking about proposed, not final regulations. If you adopt the approach agreed to by the Treasury and IRS officials having the authority and responsibility to act, industry spokesmen would have a full opportunity to present their case as to why further concessions should be made. If these further concessions -- which go beyond the bounds of what IRS (and, we believe, some Treasury) officials believe permissible -- are made now, massive loopholes will be placed in the law by hasty administrative action without the opportunity for the kind of public disclosure and consideration of the issues which is called for by the Administrative Procedures Act.

2. From not inconsiderable experience with this issue in private practice, I am extremely skeptical of industry claims which appear to be accepted as fact by some. The modifications agreed upon by the Treasury-IRS Policy Committee go, we think, as far as the statute permits and farther than necessary to achieve the reasonable objectives of those who fear that R&D will flee the country. If the IRS (and former Treasury) position is adopted, R&D simply isn't going to flee. Drug companies, for example, will probably have to pay something more in Federal taxes, but other companies are already paying the "something more".

3. Political considerations are irrelevant in IRS thinking but perhaps not in the thinking of some others. If some Treasury economists should think that forced issuance of the give-away embodied in their proposal is good politics, they are wrong. It's lousy politics.

4. In any event I believe your decision should be deferred until Charles Walker and I can discuss this matter with you personally in the light of developments at our Group of Four meeting in England this week.

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname						
Initials / Date	/ /	/ /	/ /	/ /	/ /	/ /

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DCAlexander/smd/10/9/76 -- Revised:MWhitaker/smd/10/9/76

ATTACHMENT 4

OPTIONAL FORM NO. 10
MAY 1962 EDITION
GSA FPMR (41 CFR) 101-11.6

UNITED STATES GOVERNMENT

Department of the Treasury
Washington, D.C. 20220

Memorandum

TO : Mr. Charles Walker

DATE: 10/13/76

FROM : Gary Hufbauer GH

SUBJECT: Meeting with Secretary Simon on Section 861

The meeting was held from 10:00 a.m. to 10:30 a.m., Wednesday, October 13, 1976. Those attending were: Secretary Simon, Sidney Jones, Meade Whitaker, and Gary Hufbauer.

1. Retroactivity. Secretary Simon raised the issue of retroactive application of the repropoed regulations. He had called me on this issue on October 12, 1976. I gave the Secretary the attached memorandum, and I summarized the arguments. The Secretary said that retroactive application would be "ludicrous", in light of Treasury's failure to issue these regulations at an earlier date. Secretary Simon believes that few if any companies have made provision for the new rules, and that companies deserve reasonable notice of any substantial change in tax administrative practices. He then stated that the repropoed regulation should be prospective with respect to all issues, and that the new rules should take effect for taxable years beginning on or after January 1, 1977. Whitaker pointed out that prospective application would mean that existing apportionment methods would have to be accepted as filed by taxpayers. Secretary Simon agreed that this is the intended result.

2. Interest expense. Whitaker spoke briefly against the Treasury draft with its "notch" provision, and I responded. Whitaker then suggested that we consider an average of apportionment on the basis of (1) assets and (2) gross income. He had called me with this suggestion on October 12. I had discussed the new proposal with George Carlson and John Raedel, and I told Secretary Simon that, in our opinion, it might severely undercut the rationale for the proposed regulation. The statute speaks of allocating expenses to definitely related classes of income, and ratably apportioning other expenses.



5010-108

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An average mixes both concepts together, and taxpayers would surely argue that the Treasury draftsmen did not know which horse they were riding. Secretary Simon deferred further consideration of this issue.

3. R&D Expense. Whitaker said that the Treasury draft goes "further than the law can reasonably justify." I responded that this was simply not so, and that, if the repropoed regulation were to apportion R&D expense ratably on the basis of gross income, no taxpayer or public interest group (if it had standing to sue) would prevail if it challenged the gross income method in the courts. Secretary Simon deferred further consideration of this issue.

4. Treasury-IRS Backbiting. Commissioner Alexander sent the attached memorandum to Secretary Simon before he left for London. Whitaker summarized Alexander's comments. I responded that Treasury consultation with industry was perfectly appropriate in light of:

(1) the three previous misfires on this regulation (1965, 1966, and 1973) and Treasury's corresponding desire to resolve the issue after eleven years;

(2) since Treasury's earlier proposal (the royalty method with an 80 percent cap), was widely discussed and accepted by industry, but was then shot down on administrative grounds by IRS, Treasury had an obligation to inform these groups of our latest thinking to avoid charges of gross deception; and

(3) EPB Task Force involvement ensured that a story would go out, at least in garbled form, to concerned industries.

With great restraint I refrained from answering the Commissioner's innuendos directed at the integrity of "Treasury economists".

5. EPB Involvement. Secretary Simon stated that the EPB role, from here on, would be strictly limited, and that the EPB would merely be informed of Treasury's decision.

6. Next Meeting. Secretary Simon will meet with Commissioner Alexander, Meade Whitaker, Sidney Jones, you and me, on Thursday, October 21, 1976, to reach a final decision. Sidney Jones stated that his principle concern was to reach an early decision and go forth with repropoed regulations. Secretary Simon concurred.

Attachments

ATTACHMENT 5

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Date: OCT 20 1976

MEMORANDUM FOR: SECRETARY SIMON

From: Charles M. Walker ^{Initialed CM}
Assistant Secretary for Tax PolicySubject: Proposed Regulations under Section 861: Apportionment
of R&D Expense

As indicated in my October 9, 1976 memorandum, the Treasury and IRS are far apart on the proper apportionment of R&D expense. Further attempts to resolve our differences have failed. The IRS believes the Treasury's proposal for an optional apportionment based on gross income is an unjustified "give away" to corporate taxpayers. I disagree. The sales apportionment method proposed by the IRS, while it recognizes that R&D may be less valuable abroad because of narrow and delayed application abroad, totally ignores important factors that argue for a lesser apportionment of R&D expense to foreign source income.

1. The IRS approach ignores the lag between the time a firm begins a research project and the time it first applies the findings anywhere. R&D expense is incurred today, but income is produced in the future. Thus, a U.S. multinational corporation with a growing research budget will be required to apportion to foreign sources current R&D expense which may far exceed the R&D expense of ten years ago, which in fact gave rise to this year's income from abroad.

2. The IRS approach does not recognize, as a limiting factor, the amount of royalty income received from foreign sources. Thus, it could easily require an apportionment of R&D expense to foreign sources in excess of royalties received from foreign sources.

3. The IRS proposal does not recognize the R&D expense of a foreign subsidiary. Thus, a U.S. parent firm's R&D expense will be apportioned, in part, to a

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec
Surname	Carlson	Raedel	Hufbauer			
Initials / Date	CC / 10/20	JRC / 10/22	GCH / 10/22/76	/	/	/

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-2-

foreign subsidiary that performs its own R&D and receives few, if any, research results from the U.S. parent. The IRS contends that it cannot recognize the R&D expense of a foreign subsidiary because section 861 does not authorize consolidation. But the IRS approach already involves a quasi-consolidation of parent and subsidiary sales. This fact has not escaped the notice of taxpayers who ask the vexing question: how can Treasury compel a quasi-consolidation for R&D, but not permit a quasi-consolidation for interest?

4. Treasury is very concerned that the apportionment of R&D expense to foreign source income appear reasonable to foreign tax authorities. Unless the regulation is inherently reasonable, the results will not be accepted by foreign governments in authorizing royalty payments and in setting withholding tax rates; and if the results are not accepted abroad, substantial double taxation is a certainty. Based on extensive conversations with foreign tax authorities, I am afraid that the results of the IRS approach would not be considered reasonable by them.

It would be exceedingly difficult to draft a regulation that gave explicit recognition to these four "omitted" factors. It might be impossible to administer such a regulation. But the omitted factors should not be altogether ignored, as they are in the IRS approach.

I believe that the Treasury's proposal for a gross income option represents both a reasonable and justifiable way of taking the omitted factors into account. However, both the Treasury and IRS approaches are extremely complicated, requiring 38 densely-worded pages to set forth and illustrate. Both approaches promise to be difficult to administer. If you feel that a more explicit recognition of the omitted factors raised by taxpayers is required, or if you feel that the sales method is too complex, I strongly suggest that apportionment of R&D expense on the basis of sales be abandoned entirely and that R&D expense be apportioned solely on the basis of relative amounts of gross income received from domestic and foreign

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sources. I believe that a revised draft with a gross income apportionment can be published no later than November 5, 1976.

Options

- (1) Treasury recommendation for the sales method with a gross income optional method.

- (2) IRS recommendation for the sales method without a gross income optional method.

- (3) Alternative Treasury recommendation for apportionment solely on the basis of gross income.

ATTACHMENT 6

Date: 12/21/76

MEMORANDUM FOR: SECRETARY SIMON

From: Charles M. Walker in. Hufbauer

Subject: Final Regulations Under Section 861: Allocation and Apportionment of Deductions

The hearing on the Proposed Regulation on Section 861 was held on December 16, 1976. The comments presented at the hearing, as well as those received in written form, have now been analyzed by the Treasury and IRS staffs.

The attached memorandum describes and evaluates the important comments received with respect to interest, R&D, losses, general and administrative expense, and state income taxes. The memorandum concludes with a timetable recommending a decision before Christmas if you wish to issue final regulations during this Administration.

As you know, I will be leaving town on Tuesday noon and will be gone the rest of the week, but Gary Hufbauer is familiar with all aspects of the regulation and is available to discuss it.

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname	Carlson	Hufbauer				
Initials / Date	/	in. Hufbauer /	/	/	/	/

MEMORANDUM TO: Secretary Simon
FROM: Charles M. Walker
SUBJECT: Final Regulations Under Section 861:
Allocation and Apportionment of Deductions

INTRODUCTION

The hearing on the Proposed Regulation was held on December 16, 1976. Nearly 70 written comments were received and 20 persons spoke. The comments may be divided into three broad groups: (1) those which contend the Proposed Regulation is wrong as a matter of policy, contrary to the statute, and should be withdrawn; (2) those which urge further consideration and delay; (3) those which accept or endorse early publication of a final regulation with modifications.

The arguments of the first and second groups should be rejected. The Treasury firmly believes that the Proposed Regulation implements the intent of statute. In any event, the regulation will and should be tested in the courts. The way to proceed to judicial resolution is to issue final regulations. Eleven years of staff consideration is long enough.

The important modifications suggested by commentators who accept or endorse prompt publication are summarized below. Certain other modifications of a technical nature have already been reviewed and accepted by the Treasury and IRS staffs.

INTEREST EXPENSE

A. Quasi-consolidation

Several taxpayers have argued that the assets and interest expense of their foreign subsidiaries should be taken into account when apportioning the taxpayer's own interest expense between domestic and foreign income. This proposal has been extensively considered and rejected by the Treasury and IRS staffs for several reasons.

1. Adoption of a quasi-consolidated option for interest would seriously undermine the entire regulation. Application of a quasi-consolidated method to interest expense would make it difficult to deny arguments for a similar consolidation in the case of R&D, general and administrative expense, and other

expenses. Once taxpayers are permitted to look to expenses of related parties as an offset to their own expense apportionment, the Proposed Regulation may be in conflict with the statute which requires that a single taxpayer's expenses are to be apportioned between that taxpayer's domestic and foreign income. Moreover, a quasi-consolidation approach for expenses would set the intellectual foundation for consolidation of income on a worldwide basis, hence the termination of deferral and current U.S. taxation of foreign subsidiary income, contrary to Treasury policy.

2. The quasi-consolidated approach would present the IRS with substantial administrative problems involving the valuation of foreign assets, determination of foreign interest expense, and differences in accounting methods and periods.

3. Adoption of the quasi-consolidation option would require that the regulation be redrafted and repropounded, very likely foreclosing final adoption of any regulations under section 861 during this Administration.

4. Much of the hardship which a quasi-consolidation approach seeks to avoid can be better addressed by a change in the effective date for the interest rule. This is discussed under topic C below.

RECOMMENDATION: The quasi-consolidation option should be rejected and not added to the interest section of the Proposed Regulation.

Approve _____

Disapprove _____

B. Foreign Banks

Several foreign banks have argued that application of the Proposed Regulation's interest apportionment to their U.S. operations is inappropriate in light of their methods of operation.

The Treasury staff recognizes that these foreign banks may have legitimate concerns, but believes that such concerns are appropriately resolved by the competent authorities under existing bilateral income tax treaties. The Treasury staff has informed Government officials of Germany and Japan that the problem of foreign banks can be effectively resolved through the treaty mechanism. The Proposed Regulation will include a reference to the well-established principle that treaty provisions may supercede rules of a tax regulation.

RECOMMENDATION: Do not change the principles of the Proposed Regulation, but make reference to the potential application of income tax treaties in the case of foreign corporations.

Approve _____

Disapprove _____

C. Effective Date

The 1973 version of the Proposed Regulation provided that interest, whenever paid, on obligations incurred prior to January 1, 1973, would be apportioned under methods applied prior to issuance of that version of the Proposed Regulation. The current Proposed Regulation applies prospectively to interest paid after January 1, 1977, even when paid on pre-existing obligations.

Although the interest apportionment rules have been substantially liberalized in other ways, it might be appropriate to provide a "grandfather" provision similar to that in the 1973 version in order to mitigate any hardships which could otherwise arise, for example, the Sears problem and tracing cases. In addition, a "grandfather" provision would give firms which service a large volume of consumer debt (such as Sears) time to put these borrowing activities in a separate corporation, and thereby insulate the interest expense from foreign income. In other words, if new debt obligations are issued by a separate financing subsidiary, the interest expense of the parent corporation which must be apportioned to foreign income will be substantially reduced. The use of a separate domestic financing corporation will thus mitigate or eliminate the problem of borrowing by foreign subsidiaries. An optional "grandfather" provision would permit taxpayers to apply their existing apportionment method to interest paid on obligations incurred prior to a specific date, either January 1, 1973, or January 1, 1977. The January 1, 1973 date is appropriate since taxpayers have known about new rules since publication of the 1973 version of the Proposed Regulation. The January 1, 1977 date would be considerably more generous.

RECOMMENDATION: The Proposed Regulation should adopt a "grandfather" provision for interest paid on pre-existing debt.

Approve _____
 Use January 1, 1973 _____
 Use January 1, 1977 _____
 Disapprove _____

RESEARCH AND DEVELOPMENT EXPENSE

The Proposed Regulation provides that a taxpayer has the option of apportioning its R&D expense under either a sales method or a gross income method. Liberal rules are provided to minimize any adverse impact on R&D performed in the United States.

Sales method. A taxpayer using the sales method would follow these four sequential steps.

1. R&D is identified by broad product category. Thus, sales of machinery at home and abroad would not be taken into

account for the purpose of apportioning R&D on pharmaceuticals.

2. A taxpayer's R&D expense which is undertaken solely to meet standards imposed by the U.S. Federal, state, or local governments, such as for health, safety, and pollution purposes, is allocated solely against domestic income.

3. Recognizing that R&D is more valuable at home than abroad, the taxpayer may apportion a safe haven percentage of the balance of its U.S. research expenses exclusively to U.S. income. The safe haven figure is 50 percent in 1977, 40 percent in 1978, and 30 percent in 1979.

4. The remaining R&D expense (after the allocation for government mandated research and the exclusive apportionment to domestic source income) is apportioned between domestic and foreign sources on the basis of relative values of sales.

Gross income method. As an alternative to the sales method the taxpayer may elect to apportion research and development expense on the basis of gross income, provided the apportionment to foreign income is at least 50 percent of the amount which would be apportioned under the sales method outlined above.

Taxpayers have raised four issues with respect to the proposed treatment of R&D. The issues, analysis, and recommendation are outlined below.

A. Recognition of Foreign R&D

In determining the apportionment of R&D to foreign income, taxpayers have suggested that allowance be made for any R&D expenditures incurred by a U.S. parent's foreign subsidiaries. To the extent foreign subsidiaries performed R&D, less of the parent's R&D expense would be apportioned to foreign sources.

Foreign R&D expenditures are implicitly recognized in the Proposed Regulation through the gross income option. Explicit recognition appears unwarranted for several reasons. Recognizing foreign R&D would involve the same troublesome consolidation issues described above with respect to interest. It would encourage research to be undertaken abroad, in clear conflict with the intent of Section 174 of the Internal Revenue Code, which provides expensing of R&D to encourage R&D activity in the United States. It would present IRS auditors with difficult problems in determining whether a foreign subsidiary expenditure was for R&D or some other purpose such as market research.

RECOMMENDATION: No changes should be made in the Proposed Regulation to recognize foreign R&D.

Approve _____

Disapprove _____

B. Relax the Provision on Government Mandated Research

Taxpayers have suggested that R&D expenditures be allocated only to U.S. income if they are undertaken in response to a Federal, state or local governmental mandate. This would be a relaxation of the Proposed Regulation which requires that the expenditures be undertaken solely to meet legal requirements imposed by a governmental entity.

This change would significantly weaken the Proposed Regulation as taxpayers discovered numerous R&D expenditures "in response to" a government mandate. The change would be unjustified since R&D undertaken in response to a Food and Drug Administration requirement, but also used to satisfy foreign licensing requirements, should be apportioned both to domestic and foreign income. Finally, the exclusive apportionment and gross income provisions in the Proposed Regulations are designed to ameliorate any hardships from an overly strict application of the test for government mandated research.

RECOMMENDATION: No change should be made in the Proposed Regulation to relax the government mandated test for R&D.

Approve _____

Disapprove _____

C. R&D Should be Grouped by "Natural" Product Categories

Taxpayers contend that the two-digit Standard Industrial Classification groupings are too broad and urge that each taxpayer should be allowed to classify R&D by "natural" product groupings.

The two-digit classification was placed in the Proposed Regulation because, while pharmaceutical research probably does not benefit machinery sales, pulp research may benefit sales of paper products. Going to a "natural" grouping, as defined by each taxpayer, would provide ample and undesirable opportunity to design product groups with a view to minimizing the tax consequences. IRS auditors do not have the scientific knowledge necessary to question such "natural" groupings. To the extent the two-digit classification involves hardships, liberality elsewhere in the regulation adequately compensates for any adverse impact.

RECOMMENDATION: No change should be made in the Proposed Regulation to allow taxpayers a "natural" grouping of their R&D expenditures.

Approve _____

Disapprove _____

D. Recognize the Parent's Ownership Percentage in Determining the Sales of a Controlled Corporation

The Proposed Regulation would include all the sales of a controlled corporation, defined as a corporation owned at least 51 percent by the taxpayer. Taxpayers have urged that if a U.S. parent corporation owns 51 percent of the stock in a subsidiary, then only 51 percent of the subsidiary's sales should be included for purposes of apportioning the parent's R&D expense. With appropriate safeguards, this seems to be a reasonable change.

RECOMMENDATION: Change the Proposed Regulation to reflect the parent's ownership of a foreign subsidiary.

Approve _____

Disapprove _____

E. Exclusive Apportionment Percentage

Many taxpayers have argued that the exclusive apportionment of R&D expense to U.S. income should be kept at 50 percent, rather than the 50%-40%-30% approach of the Proposed Regulation.

The exclusive apportionment was placed in the Proposed Regulation to recognize the fact that R&D is most valuable where performed. For several reasons, the figure should not be permanently set at 50 percent. Fifty percent is probably too high and was only placed in the regulation as a transitional rule to soften the immediate impact. Thirty percent seems more appropriate on a long-term basis. In conjunction with the gross income optional method, a 30 percent exclusive apportionment means that a large corporate taxpayer, with half its sales abroad, would apportion less than 20 percent of its R&D to foreign income. Indeed, an exclusive apportionment in excess of 30 percent may in some cases (such as IBM) permit a lower apportionment of R&D expense to foreign income than is made under existing regulations. The Proposed Regulation already permits a taxpayer, on a showing of its facts and circumstances, to claim a higher exclusive apportionment than 30 percent. Finally, the 50%-40%-30% arrangement was agreed to only with great reluctance by the IRS which believes that even 30 percent is unreasonably high.

RECOMMENDATION: No change should be made in the 50%-40%-30% exclusive apportionment schedule of the Proposed Regulation.

Approve _____

Disapprove _____

LOSSES

A few taxpayers have argued that the rule in the Proposed Regulation which allocates losses on the sale of property to the class of income which such property ordinarily gave rise should be changed to conform to the present rule for determining the source of gains on the sale of property. In other words, the loss would be sourced where title to the property passes.

Both Treasury and IRS agree that the present source rule for gains is inappropriate, but that it can be changed only by amending the statute. Nothing in the statute, however, precludes a more appropriate rule for the allocation of losses. Treasury and the IRS believe that the loss rule in the Proposed Regulation better reflects economic realities and is less subject to taxpayer manipulation than the gain rule. A loss rule which follows the gain rule would permit taxpayers, at their discretion, to determine the source of a loss, on the sale of property regardless of where that property may have produced gross income.

RECOMMENDATION: Retain the rule in the Proposed Regulation.

Approve _____

Disapprove _____

GENERAL AND ADMINISTRATIVE EXPENSE

The Proposed Regulation apportions a part of G&A expense to foreign source income. Taxpayers with self-sufficient international departments have expressed concern that the IRS may still attempt to apportion other G&A expenses to foreign source income. The regulation can be revised to make it clear that no further apportionment would be required in such situations.

RECOMMENDATION: Revise the Proposed Regulation to clarify the apportionment of G&A expense.

Approve _____

Disapprove _____

STATE INCOME TAXES

Under the Proposed Regulation, the deduction for state income taxes is apportioned to foreign income, to the extent those taxes are imposed on foreign income as defined under Federal law. Many taxpayers have urged that no apportionment should be made where the state, in its own statute, declares that it uses an income apportionment formula only for the purpose of reaching in-state income. However, such states may in practice tax foreign income as defined under Federal law. The Proposed Regulation makes clear that if state taxes are imposed in part on foreign source income, they should be apportioned in part to foreign source income.

RECOMMENDATION: There should be no change in the principle that the deduction for state income taxes imposed on foreign income, as defined by Federal law, should be apportioned to foreign income.

Approve _____

Disapprove _____

TIMETABLE

If a final regulation is to be issued during this Administration, a target date of January 3, 1977 should be set for publication. After that date, key senior personnel will be leaving the Treasury and the IRS, and key staff members will be abroad on treaty negotiations and away on annual leave. In order to meet the January 3, 1977 target, final decisions should be made before Christmas. You may wish to advise the EPB of your decision and give its members a chance to comment.

RECOMMENDATION: Eleven years is long enough to consider a single regulation. Taxpayers can and should litigate their objections in court. I strongly urge that you approve the publication of this regulation in final form on January 3, 1977.

Approve _____

Disapprove _____

Chairman RANGEL. Let me beg to interrupt here.

I had hoped that staff would have advised the witnesses that in order to achieve our goal here and to cover the entire witness list by 1:30 that the witnesses should be advised that the entire statements will be placed in the record, but we are asking for a 5-minute summary so that we can cover the entire scope of the testimony this morning.

So with that in mind, I hope that you will be able to summarize. I had hoped that staff would have advised the witnesses that we need your cooperation.

Mr. HUFBAUER. That concludes my statement, Mr. Chairman.

Chairman RANGEL. Mr. Lokken, New York University.

STATEMENT OF LAWRENCE LOKKEN, PROFESSOR OF LAW, NEW YORK UNIVERSITY SCHOOL OF LAW

Mr. LOKKEN. I am Lawrence Lokken, I am a professor of law at the New York University School of Law. I am not representing the University or any other organization. I am appearing just on my own.

I come to talk to you about what Congressman Shannon called earlier this morning "pure tax policy" because that is about the only thing I know that you might be interested in. I think that the arguments on pure tax policy grounds have been pretty much agreed upon by the witnesses that have come before me. Let me summarize very briefly.

What we are talking about here is the foreign tax credit of course. The foreign tax credit is a mechanism allowed by the United States to alleviate double taxation. Foreign countries tax only foreign source income when the taxpayer is a U.S. person and hence the credit is limited to the U.S. tax which is allocable to foreign source income.

The tax generally is the tax on net income and hence foreign source income is defined also as a net concept, very basically foreign source income being gross income from foreign sources reduced by the cost of earning that foreign source gross income.

The maximum credit, therefore, is the U.S. rate multiplied by that net foreign source figure. It seems agreed at least in concept that some portion of research and development costs ought to be allocated to foreign source income if a company used its R&D product in foreign production activities, and that is precisely what the regulations have provided. That is precisely what the 1981 moratorium has forbidden.

So the issue it seems to me is whether R&D expense should be treated like any other expense in this regard. That is, whether a part of R&D expense should be allocated to foreign income to reflect the fact that R&D is used abroad or whether there should be something special about R&D, namely, whether we should allow R&D expense to be allocated only to U.S. income notwithstanding it is used in part to earn foreign income.

My conclusion on the basis of pure tax policy is that the latter course is wrong, that this moratorium should be allowed to lapse and nothing should be substituted in its place.

The regulations have, I think, been described already. I would like to point out, perhaps just to emphasize what has been said to you before, that the regulations are not in this context imposing some draconian penalty. The regulations have taken a very soft stand about research and development expenditures. Mr. Hufbauer says he was afraid when the regulations were put out that the Treasury would be accused of making some huge giveaway to multinational companies. As I point out in my statement, if a company uses its R&D for production in the United States and in foreign countries more or less equally in the two countries, it would seem in the abstract that the R&D expense should be split down the middle and allocated to each. The 1977 regulations on the other hand would allow in that case an allocation of just 17.5 percent to reflect the use of R&D half in foreign countries.

So the regulations are designed to take into account the very concerns that are pressed by industry in favor of this moratorium and I really believe that that is sufficient.

Departing from the realm of pure tax policy, I have some commentary at the end of my statement about some of the economic consequences of the moratorium. Most of this is drawn from the Treasury report.

Let me just emphasize one or two points. One is that the number of tax dollars involved here—at least in relationship to total research and development expenditures—is very small. Therefore, it seems to me that the effect upon our R&D activity from this regulation must be very small.

On the other hand, we are talking about a sum of \$100 million in tax revenues. We have in this country a very large deficit these days. My observation in looking at the tax law for many years is that much of that deficit is attributable to the fact that the tax code is very leaky. Congressman Shannon referred to the fact that the code is full of special tax breaks. It seems to me that that is the problem. That is not the solution.

This is an instance in which we ought to let one special concession lapse.

Thank you.

[The prepared statement of Mr. Lokken follows:]

STATEMENT OF LAWRENCE LOKKEN, PROFESSOR OF LAW, NEW YORK UNIVERSITY
SCHOOL OF LAW

My name is Lawrence Lokken. I am a Professor of Law at the New York University School of Law, 40 Washington Square South, New York, New York 10012. I am also a Research Associate of the International Tax Program of Harvard Law School. In the latter capacity, I have been engaged since 1976 in a study of the source of income rules of the federal income tax law, a study which will culminate in a book to be entitled, "The Sources of Income: A Study of the Role of Source Concepts in the United States Taxation of International Business and Investment Income." In my appearance today, I do not represent New York University, the International Tax Program, or the Harvard Law School. I appear only as an interested citizen.

THE ISSUE

The Internal Revenue Code allows a credit against U.S. income taxes for income taxes paid to foreign countries. The credit is allowed to alleviate double taxation. It is generally allowed only to citizens and residents of the United States and domestic corporations. The theory underlying the credit is that when a United States person earns income abroad, primary jurisdiction to tax the income should lie with the foreign country that is the source of the income, and the United States should tax the

income only to the extent that the foreign tax is less than the tax the United States would normally impose.

Because the credit is allowed to eliminate double taxation, the credit is allowed only against the U.S. tax on foreign income. Since foreign countries tax United States persons only on income originating in these countries, no reduction of U.S. taxes on domestic source income is needed to eliminate double taxation. The maximum allowable credit for foreign income taxes is thus the U.S. tax, before credit, on foreign source income. Generally, for a large company, the maximum credit is 46 percent of foreign source income, and the net U.S. tax on foreign source income is 46 percent of the income less the taxes on the income imposed by foreign countries. Foreign source income is measured for this purpose by source rules found in our law, not the laws of the foreign countries that impose the taxes for which credit is claimed.

The federal income tax is a tax on net income, that is, a tax on the excess of gross income over allowable deductions. Generally, this means that taxable income is gross receipts, reduced by the costs incurred in earning them. The U.S. tax on foreign source income thus can be determined accurately only if foreign source income is also defined as a net figure. The law has so provided for six decades. More particularly, the maximum credit is the U.S. rate multiplied by the taxpayer's "taxable income from sources without the United States," and the quoted words are defined as the excess of gross income from sources outside the United States over the deductions "properly apportioned or allocated thereto." Foreign source income thus is generally gross receipts from sources outside the United States, less the costs incurred in earning these foreign receipts.

The issue before this committee today is whether research and development costs should be among the costs governed by these general rules or should be subject to a special regime. Research and development costs are usually deducted as incurred, even though the costs are typically expected to yield benefit far into the future. If a company's patents and know how are used in producing goods both in the United States and foreign countries, research and development costs are incurred in order to earn income from foreign as well as domestic sources. In this case, the general rule described above—that foreign source income is gross receipts from foreign sources less the costs incurred in earning these receipts—requires that the deduction for research and development costs must be allocated partly to foreign source income. This allocation would reduce taxable income from sources without the United States and thus would cause the maximum credit for foreign income taxes to be smaller than it would be if research and development costs were ignored in determining the credit.

The Congress decided in 1981 that there should be a special rule for research and development costs, at least temporarily. It provided in § 223(a) of the Economic Recovery Tax Act of 1981 that for two years all deductions for the costs of research and development done in the United States should be allocated to domestic income.

During this two year period, the treatment of research and development costs is unique. The general rules continue to apply to all other business costs. That is, taxpayers still must subtract from foreign source income at least a portion of all costs other than research and development costs that are incurred, in whole or in part, to generate foreign income. A research and development cost is the only cost that may be ignored in determining foreign source income even if it is incurred to earn foreign as well as domestic income.

This unique treatment for research and development costs conflicts with the policy that the foreign tax credit should serve only to eliminate double taxation. When foreign source income is determined without subtraction for all deductible costs incurred in earning gross income from foreign sources, the foreign source income figure is artificially inflated, and the maximum credit is thereby enlarged. The maximum credit is thus larger than the precredit tax fairly allocable to foreign source income. The credit is thereby allowed to offset not only foreign source income but a portion of domestic source income as well. The allowance of a foreign tax credit against U.S. tax on income from domestic sources is not justified by the policy to eliminate double taxation. It is simply a subsidy for the specially treated item, research and development costs.

The issue before this committee today is whether this special treatment for research and development costs should be continued. I urge that it not be.

THE REGULATIONS

The Treasury promulgated regulations in 1977 which apply the general rules described above to research and development costs. For companies that do most of

their research and development in the United States, the regulations require a lesser allocation to foreign source income than the general rules might imply. If a company produces $\frac{1}{2}$ of its goods in the United States and $\frac{1}{2}$ of its goods in foreign countries, for example, it might seem that $\frac{1}{2}$ of its research and development costs are incurred to produce foreign income and that this $\frac{1}{2}$ should be taken as a deduction from foreign source income. Regulations proposed in 1973 would have so provided, but in response to industry complaints the final regulations were much made less rigorous. In the example above, the regulations might allow as little as 17½ percent of the research and development costs to be allocated to foreign source income.

THE ARGUMENTS FOR SPECIAL TREATMENT FOR RESEARCH AND DEVELOPMENT COSTS

Two arguments are given in the regulation as justifications for the liberality towards taxpayers shown in the final regulations on research and development. These arguments might also be made in support of a rule allocating to domestic source income all costs for research and development work done in the United States. It is argued that research and development costs are most valuable to a taxpayer in its home country, if its research and development work is done there, because (1) all successful products resulting from this work are likely to be produced at home whereas only some may be produced abroad and (2) products are usually produced first at home and only later abroad.

The arguments are not persuasive. The general approach of the regulations is to apportion research and development costs in proportion to sales of goods produced here and abroad, respectively. If a taxpayer uses its patents and know how less extensively in foreign production than in domestic production, the lesser use abroad will be reflected in smaller sales figures for foreign production. If this lesser foreign use is also reflected by an arbitrary additional allocation of research and development costs to domestic sources, it is counted twice in the apportionment formula. Because the lesser use abroad is fully accounted for in the apportionment by sales, the added allocation is a distortion.

Industry arguments about the allocation of research and development costs often take another tack. If research and development costs are allocated to foreign income for U.S. tax purposes, but the amounts so allocated are not deductible in determining foreign tax liabilities, the foreign tax may exceed the maximum credit even if the foreign rate is no higher than the U.S. rate. Assume a U.S. company does research and development in the United States and produces goods embodying the resulting patents and know how in the United States and a foreign country, country X, that taxes income at the same rate as the United States. If U.S. allocates \$10 of research costs to income from country X and country X allows this \$10 as a deduction in determining country X tax, the amount the U.S. treats as foreign source income equals the amount country X taxes. The country X tax in this case equals the maximum credit under U.S. law. If country X does not allow the deduction for research and development costs, in contrast, country X taxes more than the amount deemed to be from foreign sources under U.S. law, and the country X tax exceeds the maximum credit. The company pays more tax worldwide in this case than it would have if it had confined its activities to the United States.

In this last case, however, the company has no valid argument for a larger foreign tax credit. The function of the credit is to eliminate double taxation, not to insure that the tax cost of doing business abroad will be no greater than the tax cost of doing business at home. Generally, the rule that limits the credit to the U.S. tax on foreign income means that the aggregate rate of tax, U.S. and foreign, on foreign source income is the higher of the U.S. or foreign rate. If a company is taxed abroad 52 percent, for example, its credit against U.S. tax is only 46 percent of foreign source income, not 52 percent, and its final tax burden is 52 percent, the foreign tax, not 46 percent, the U.S. rate. A higher foreign rate is only one of several factors that can cause a foreign tax to be larger than the U.S. tax. If a foreign country taxes income that is exempt in the United States or denies a deduction allowed in the United States, the consequence can also be a higher foreign tax. The applicable principle is the same, however, regardless of the cause of a higher foreign tax—credit against U.S. tax is given only against the U.S. tax on foreign income, before credit, and the additional foreign tax is borne by the taxpayer. Section 223(a) of the Economic Recovery Tax Act of 1981—the subject of this hearing—is the first statutory departure from this principle since it was established in 1921.

The industry complaint in the case discussed here is really a complaint against discriminatory foreign taxation. The allegation is that the research and development deductions which the Treasury regulations would allocate to foreign income

usually are not deductible in computing foreign taxes if the research and development is done in the United States but would be so deductible if the research and development were done in the foreign countries imposing the taxes. The complaint, however, is misdirected. If U.S. companies are subject to discriminatory foreign taxation, their complaint should be directed to foreign tax administrators, and the U.S. Treasury should aid them in pressing the complaint. The complaint should not be remedied by increasing the foreign tax credit because such a solution causes the cost of the foreign discrimination to fall entirely on our fisc and removes any incentive for U.S. companies doing business abroad to insist on their rights under the tax laws of their host countries to fair taxation.

The costs of the discrimination, furthermore, are probably not as significant as might at first appear. U.S. companies do not commonly do manufacturing in foreign countries through unincorporated divisions. Usually, foreign manufacturing is done through foreign subsidiary corporations. A U.S. parent of a foreign manufacturing subsidiary often licenses to the subsidiary patents and know how obtained through research and development in the United States. In such a case, the foreign tax issue is the deductibility of royalties paid by the foreign subsidiary to the U.S. parent. Tax administrators in some of the principal host countries for foreign manufacturing operations of U.S. companies, particularly West Germany, have been notoriously stingy in allowing deductions for royalties paid to U.S. parents. The royalties are taxable to the parents in the United States, however, and the Internal Revenue Service has the power under § 482 to increase a royalty which is insufficient compensation for the rights given to a foreign affiliate by license.

An insufficient foreign deduction for a royalty, however, usually does not put a U.S. company in a particularly adverse position, however. Royalties often bear little foreign tax. If a royalty is deductible by the foreign subsidiary that pays it, the funds so paid are thereby relieved from the foreign corporate tax normally imposed on the subsidiary. Foreign countries often impose withholding taxes on the recipients of royalties paid out from them, but these taxes are commonly waived or sharply reduced by treaty. The tax treaties the United States has with West Germany and the United Kingdom, for example, exempts U.S. companies from German and U.K. tax on royalties received from German and U.K. subsidiaries. The U.S.-France treaty reduced to 5 percent the French tax on royalties received by U.S. companies from French sources. A royalty from a West German or British subsidiary is thus free from all foreign tax to the extent it is deductible in computing the German or U.K. tax, and a deductible royalty from a French subsidiary bears a foreign tax of only 5 percent. These royalties nevertheless are deemed foreign source income in determining the foreign tax credit under U.S. law. When foreign source income is exempt from foreign taxes or is lightly taxed abroad, the limitation on the foreign tax credit is inflated, with the consequences that the credit for foreign taxes on other income is increased.

If the deduction allowed a foreign affiliate for a royalty paid to a U.S. company is smaller than is appropriate, in sum, the consequence may be only that the U.S. tax windfall just described is reduced. Many U.S. based multinational enterprises are burdened with foreign taxes that exceed the foreign tax credits allowed to them in the United States. They are, in the jargon of the trade, in excess credit position. I do not have access to records that show the reasons for this situation. I strongly suspect that it has not resulted from the treatment of research and development costs or royalties. More likely, U.S. companies have looked to the international rules for royalties as a means of solving foreign tax problems that originate in the treatment of other items.

ALLOCATION RULES AS A SUBSIDY FOR RESEARCH AND DEVELOPMENT

The foregoing shows that § 223(a) of the Economic Recovery Tax Act of 1981—the rule prohibiting any allocation to foreign income of research and development costs incurred in the United States—can be justified only as a subsidy for research and development activities. In June of this year, the Treasury submitted a report to the tax writing committees of Congress on the allocation of research and development costs. It gives several facts that are relevant to whether § 223(a) provides an efficient and appropriate subsidy. Some of them (and my comments on them) are summarized below:

1. The number of tax dollars foregone by § 223(a) is too small to provide a significant stimulus for research and development. It is estimated that § 223(a) reduces tax liabilities by between \$100 and \$240 million, significantly less than one percent of private expenditures for research and development in the United States.

2. About 85 percent of this tax subsidy passes to 24 of the 100 largest corporations in the United States.

3. The subsidy goes only to those companies that have production facilities abroad. The regulation overridden by § 223(a) does not apply to companies that produce goods in the United States for export to foreign countries. The subsidy, if it causes business to alter its activities at all, thus will encourage companies to satisfy foreign markets with foreign production rather than by the export of goods produced in the United States by American workers.

4. The subsidy does not significantly benefit emerging industries where newly developing technology is most important.

The last paragraph of the Treasury Report states the present Treasury position that § 223(a) should be given an additional two years of life because a termination of the subsidy might reduce research and development to an extent that "may adversely affect the competitive position of the United States." This last assertion finds no support in the Report. On the contrary, it is squarely contradicted by the principal portions of the analysis stated in the Report. The Committee should disregard the last paragraph of the Report, and give heed to the unavoidable implication of the preceding 32 pages of the report. Section 223(a) should be left to die a quiet death.

Chairman RANGEL. Mr. Duncan.

Mr. DUNCAN. I want to thank you, gentlemen. I have no particular questions.

Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Hufbauer, when you were doing your work with the Treasury regulation was there any discussion by IRS, Treasury or the industry concerning a possible allocation rule that would allocate all R&D to U.S. sources?

Mr. HUFBAUER. Mr. Chairman, I didn't quite hear your question. That would allocate all R&D to—

Chairman RANGEL. To U.S. sources.

Mr. HUFBAUER. Oh, no, that was not discussed because that seemed inconsistent with section 861.

Chairman RANGEL. What were the main concerns industry had with the early versions of the Treasury regulation?

Mr. HUFBAUER. Industry felt it would be inaccurate as an accounting matter, and would have draconian consequences on the location of research facilities, if the thrust of those early regulations—namely, to allocate R&D on the basis of sales performed at home and abroad—had been carried out.

Roughly speaking if the corporation had \$50 million of sales abroad and \$50 million of sales at home and it performed all its research at home, half of the research expense would have been attributed to foreign income. That was a danger of very great concern to industry.

Chairman RANGEL. Professor, you discuss the purity that does exist in the tax law but in trying to reach some form of allocation of R&D expenses, there are of course political considerations. What method would you suggest that would be equitable in terms of allocation?

Mr. LOKKEN. Well, what I might suggest in the abstract is perhaps different from anything anyone is considering, but it seems to me that the allocation which is provided by the regulations now on the books is the minimum that can be allocated to foreign source income in any system that pays any attention to broad concepts in the matter of allocating R&D expense.

Chairman RANGEL. How do you respond to the industry's suggestion that without the moratorium that we would lose jobs and the benefits of research overseas?

Mr. LOKKEN. Well, again this is an economic matter in which I have to rely principally on the Treasury's report. The Treasury concluded, after extensive consideration, that it was very unlikely there would be any movement. Mr. Kingson points out, also, that a company considering moving R&D abroad would be moving into a very uncertain situation in comparison to the very modest increase in cost that would be caused by the regulations.

Perhaps there is also another offsetting consideration; that is, that in the very unequal allocation of the benefits of this moratorium, the benefits go only to companies that produce in foreign countries. They do not go to the benefit of companies that do R&D in the United States, manufacture goods in the United States and then export them to foreign countries. It may be that the effect of the moratorium is to make it easier to manufacture in foreign countries as against produce for export in the United States. If that is so, it seems to me there might be many more jobs than a few R&D jobs that ought to be considered here.

Chairman RANGEL. The committee thanks both of you for your testimony. Please give our regards to President Brademas from his former members and congratulate him on the great work he is doing as president of a great university.

Mr. LOKKEN. I will do that. Thank you.

Chairman RANGEL. The Congress is fortunate to have returning to us Cec Heftel, an outstanding member of the Ways and Means Committee, a great advocate for the moratorium, and chief sponsor of the legislation we are considering here today. We look forward to his testimony this morning.

STATEMENT OF HON. CECIL (CEC) HEFTEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF HAWAII

Mr. HEFTEL. Thank you, Mr. Chairman. I am delighted to be back.

Chairman RANGEL. Welcome home.

Mr. HEFTEL. Hello, Mr. Duncan.

Mr. DUNCAN. How are you.

Mr. HEFTEL. Mr. Chairman, I would ask unanimous consent that my testimony be placed in the record and I would just like to talk with the members and the chairman about how I became involved in the subject matter because it doesn't affect my constituents nor have anything to do with any of the business planning or the business centered in Hawaii.

It wasn't hard to figure out—going back to 1976 and 1977—that the United States was losing ground in terms of productivity. I was not a member of the Ways and Means Committee at that time, and I centered my activity on just what was happening in the United States. And why we were losing ground to other countries. In the course of that investigation I came up with a number of things, one of which happened to be section 861 of the Internal Revenue Code.

Then I became a member of this committee, and I endeavored to find out why we perpetuated section 861 when we were the only country in the so-called competitive economic world that had such a provision.

The answer I came up with was "tax policy."

People living in the world of the Treasury Department, in a world that at times does not relate to what is happening outside of the establishment of tax policy, somehow convince themselves they can ignore the real economics of life.

According to the Arthur Andersen study, R&D by U.S. firms is growing faster in foreign countries than in the United States. It is understandable and almost mandatory that companies involved are, A, multinational, and B, very large.

But the fact remains that, although they are multinational and large, to the extent they determine whether R&D will be conducted in the United States or a foreign country, their size and nature make no difference to us.

Our concern is that R&D take place in the United States. A very competitive world exploits our disadvantage in that respect.

If you could rely upon patriotism, then we would have no problem. In the name of patriotism, multinationals, large corporations, or smaller corporations planning ahead, would say, "In the name of benefit to our Nation we will not place our R&D in foreign countries."

But they don't place patriotism first. They place profit first.

To the extent that profit is what motivates them, nothing we do is going to stop the movement of R&D to foreign countries if they gain financially from so doing.

The only way we can stop that again is by eliminating the section 861 allocation rules. It is from that viewpoint that I come to speak with you today, that I encourage the members to seriously consider not tax policy, but economic policy, competitive productivity of the United States, because that is the issue.

The 100 million or 120 million revenue impact involved is not the issue. The issue is what are we losing by conducting our creative R&D in foreign countries.

The Treasury numbers are hard to use. One extreme says you can use the following formula, for every dollar of tax that we supposedly save, \$2.60 of R&D occurs in foreign countries. Now, that same number can be reduced to below \$1 taking still other numbers that are proposed. In any event, the multiplier effect of R&D in terms of sales is so great that if you just said it was one for one, for \$1 of tax savings you lose \$1 of R&D—but then you multiply \$1 of R&D by I don't know how many numbers—is it 20, 30, 40, 50 times?

But certainly it is a very large number that you multiply by because R&D produces great gross revenues. So from the standpoint of productivity and economic policy, ignoring the pure tax policy concept, ignoring the testimony and insight of people who drafted this concept in the Treasury Department in the first place and who still do not pretend that they are focusing on economic policy, I would hope that we would come to the conclusion that this issue revolves not around tax policy, but economic policy and productivity.

I thank you for the chance to get together and talk again which is my first time in about 6 months, and to the extent that I am capable, I would be delighted to enter into any dialog that you may wish.

[Mr. Heftel's prepared statement follows:]

STATEMENT OF HON. CECIL (CEC) HEFTTEL, A REPRESENTATIVE IN CONGRESS FROM THE
STATE OF HAWAII

Mr. Chairman and members of the Subcommittee, I am indeed very pleased to be here to testify today on the important tax question of the allocation of domestic research and development expenditures. Twenty-two members of the Ways and Means Committee now cosponsor H.R. 1887, legislation I have introduced to provide that all domestic R and D expenditures be permanently allocated to domestic earnings. Thus, my views on this issue are clear: Congress should move quickly to enact the legislative solution contained in H.R. 1887 before the end of this calendar year, when the current moratorium on the Internal Revenue Service's regulations under Section 861 of the Code effectively expire.

First and foremost, it is extremely important that we recognize that the allocation rules under Section 861 for research and development expenditures do indeed play an important decisionmaking role for companies in determining where their new R and D facilities will be sited. And, we are not just talking about Fortune 500 companies.

We are also talking about small, growing companies that are now on the cutting edge of the new industrial revolution that is occurring in this country and around the world. Smaller companies may not now have excess foreign tax credits so that they are affected by Section 861 and Regulation Section 1.861-8. But, it does not take an extraordinary amount of foresight to anticipate in their planning that such a day may come.

As a general rule, there are legitimate tax policy reasons for allocating expenditures to the income that they generate. This tax allocation procedure dates back to 1921, when Congress made its first serious effort to grapple with the problem of foreign versus U.S. source income. However, there are some areas, some of which we have recognized statutorily, that defy reasonable allocation procedures. Indeed, in the case of R and D expenditure allocation, our experience bears out that such allocation is not only inordinately complex but directly contradicts other important policy goals.

Mr. Chairman, lately we have been hearing a great deal about the need to develop a nationwide industrial policy for our country. Maybe it is possible to have a federally guided national industrial policy. Maybe it is not.

One thing is certain, however. We must not create a negative industrial policy—one that works against this country's best interests. We should certainly not be providing incentives through our Tax Code for the export of U.S. R and D, and with it the export of U.S. jobs.

If we have a goal or policy, it is to increase America's competitiveness in the international marketplace. We are certainly not going to realize that goal or effectuate that policy by encouraging our companies to locate their R and D—and thereby their product licensing and manufacturing—overseas. Our Tax Code simply should not contain such a negative incentive at a time when we are looking desperately for meaningful solutions to improving our international competitive position.

The United States is the only country in the world that requires the allocation of domestic research and development expenses to foreign-source income, according to the Arthur Andersen study that came out earlier this year. In fact, many other countries are working long and hard to attract and stimulate research and development activities within their borders. Moreover, U.S. company R and D is growing faster in foreign markets than in the United States.

There are two other points that should be made here. First, the question of who provides those jobs or how big that provider is does not seem particularly relevant here. By definition, only multinational corporations are affected by Section 861. It stands to reason as well that the bigger the corporation, the bigger the R and D budget, and the bigger the impact that Section 861 would have on its R and D activities.

Second, as this Subcommittee moves to formulate its recommendations to the full Committee for action on the 861 issue, I hope that you will give careful attention to the permanent solution to this problem that is proposed in H.R. 1887. Although another two-year extension of the existing moratorium, such as the Treasury Department has suggested, may have some appeal, such a temporary extension will only serve to perpetuate an uncertain climate for R and D siting.

Finally, Mr. Chairman, I would like to call your attention to another study that has been conducted on the impact of Section 861 and Regulation Section 1.861-8 on the location of R and D activity. This past June an article by Christopher Buja appeared on this subject in Tax Notes Magazine, in which Mr. Buja concludes: "Re-adoption of section 1.861-8 of the regulations will exert pressure to decrease United

States R&D. . . . Short of changing the practices of foreign nations, the second-best solution . . . is to adopt a similar tax stance in the U.S. international tax codes and not to force the U.S. firms to apply unilaterally deductions which are not recognized in foreign tax systems." I am attaching a copy of this article to my written statement and request that it be included in the record of this hearing.

It is time that this government and this country recognize the important steps that must be taken to restore industrial productivity and to regain our position in the industrialized world. Enacting the permanent solution contained in H.R. 1887 to the problem created by regulation 1.861-8 is but one of the steps we should be taking to realize these vital goals. It is a very important step. We must move quickly to eliminate once and for all this significant disincentive to domestic research and development activities.

Thank you.



THE EFFECT OF SECTION 1.861-8 REGULATIONS ON THE LOCATION OF R&D ACTIVITY

by Christopher Buja

Christopher Buja is a student at the Woodrow Wilson School of Public and International Affairs at Princeton University. He would like to express thanks to Assistant Professor Don Fullerton, and to Sally Blount, David Seide, Peter Mayewski and Bonnie Crater for their suggestions and assistance.

In this article, Buja describes the development of the controversy surrounding the section 1.861-8 research and development allocation regulations. He then constructs a model to examine the likely corporate response to reinstitution of the section 1.861-8 rules. He concludes that the moratorium on those allocation rules should remain in effect as a means of stimulating the American international trade sector.

I. Introduction

In today's international economy, research and development (R&D) is an invaluable agent in strengthening American business in the face of foreign competition. A recent study linked 45 percent of the growth in U.S. productivity to industrial innovation. Consequently, the U.S. government has taken several steps to create a more favorable climate for R&D. This paper examines one such measure, the two-year moratorium placed on Treasury Regulation 1.861-8 as part of the 1981 Economic Recovery Tax Act. This article models corporate decisions about R&D location and in particular, the likely influence on those decisions of reinstitution of the section 1.861-8 rules. This model helps us determine whether the end of the moratorium will adversely affect the growth of R&D in the United States.

Section II of this article describes the historical treatment of R&D, especially the mechanisms embodied in regulation 1.861-8. Section III looks at the interaction between R&D expenses and foreign tax credits and shows how to calculate the limitations on the foreign tax credit. Based upon these calculations, Section IV builds a model to quantify the corporate response (in terms of R&D location) to the reinstitution of the section 1.861-8 rules. Section V discusses the results of this modeling exercise, and Section VI points out the model's limitations. Finally, Section VIII examines the implications of these results for domestic firms and for American R&D.

II. Background

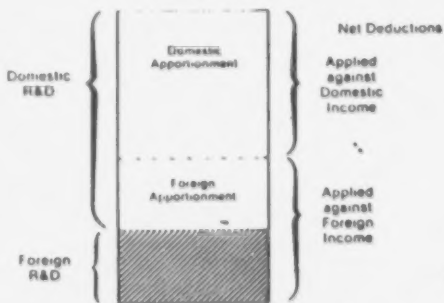
R&D expenses traditionally have been considered a business expense and thus have qualified as a deduction

from taxable income. This deduction acts as incentive for R&D by reducing the tax paid by the firm. Until 1981, this deduction was divided between U.S. and foreign income. Due to the interaction with the foreign tax credit as described below in Section III, American firms prefer to apply the entire deduction against their domestic income.

In 1981, firms were permitted to do precisely that, as a result of suspension of the regulation which had governed the distribution of the R&D deduction since 1977. The moratorium on the regulation was included as part of the Economic Recovery Tax Act of 1981 in the interest of facilitating R&D in the United States. This moratorium is only temporary. Regulation 1.861-8 will be reinstated in 1983, unless Congress acts to extend the moratorium or make it permanent. Before examining the future R&D environment, a brief history of the tax treatment of R&D deductions as well as an examination of the section 1.861-8 mechanisms may be helpful.

Figure 1

TREATMENT OF R&D EXPENSES FOR DEDUCTIONS: GENERAL APPROACH



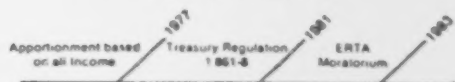
The division of total R&D deductions is depicted in Figure 1. The shaded area represents actual foreign R&D, which is applied automatically against foreign income. The unshaded region indicates United States R&D. The deduction for expenditures is subdivided into domestic and foreign components through some form of tax regulation. The net effect for the company is shown at the far right as the division into the foreign and the domestic

deductions. The total foreign deduction is the sum of the actual foreign expenditure and the portion of United States R&D expense which is to be set against the foreign income.

Since the shaded part of Figure 1 is never deducted against domestic income, this article is concerned primarily with the apportionment of the unshaded region.

The regime governing the subdivision of the U.S. segment of the R&D deduction has changed several times. The timeline in Figure 2 illustrates the evolution of the rules governing this subdivision.

Figure 2
TIMELINE OF METHODS FOR APPORTIONMENT
OF R&D DEDUCTIONS



Prior to implementation of section 1.861-8 of the regulations in 1977, corporate deductions for research and development were divided according to the relative weights of domestic and foreign income. This tally of income included all revenue sources, even income unrelated to research work.¹ As a consequence, unrelated foreign income reduced U.S. deductions for R&D and increased implied deductions abroad. This shift created a problem for some firms because it reduced the foreign tax base which could be used to calculate the U.S. foreign tax credit, and thus generated excess credits.² These credits could not be recovered, even though under the intent of the R&D deduction, the company was entitled to them.

In 1977, Treasury responded to this problem by proposing Regulation 1.861-8. The regulation eased the foreign tax credit problem by reducing the effect of unrelated foreign income. This was done by subdividing the aggregated worldwide income into the two-digit Standard Industrial Code (SIC) categories. The SIC divisions split all goods and services into 33 smaller blocks. Appendix 1 contains a list of the SIC categories. This compartmentalization of the taxable income served to reduce the skewing effects of unrelated foreign income. Domestic and foreign income generated by the research would equally support the deduction. Benignati (1981) pointed out, in fact, that one stipulation created a loophole which could be used to reverse the skewing effects back in favor of domestic income.³

¹As an example, if 80 percent of all income were earned in the U.S., then 80 percent of United States R&D would be applied as a domestic deduction. The remaining 20 percent would be applied against foreign income.

²See Section III below.

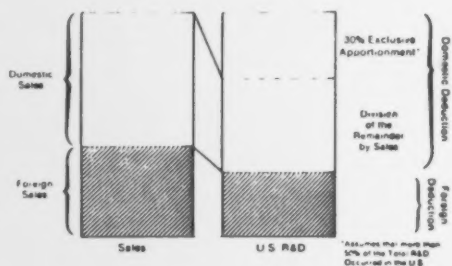
³The taxpayer may aggregate the SIC categories at his discretion which could be perleyed into distortions favoring domestic income. To do this, a company would need a SIC category which consisted entirely of domestic income. That category could then be combined with a second category which included foreign income. A larger portion of the R&D expenditures in the second division would be apportioned against domestic income than if the two categories had been calculated separately. See footnote seven, *infra*.

Within each SIC subgroup, a taxpayer had the option of calculating the deduction division by either of two different methods.

The *sales method* permitted the first 30 percent of the deduction to be allocated to the region in which more than 50 percent of the research was undertaken. The remainder was divided according to the relative levels of the domestic and foreign sales within each SIC category.

This method is illustrated in Figure 3. In this figure, the column on the left is the proportion of foreign sales to total sales. The column on the right represents the total R&D deduction for domestic expenditure. The upper 30 percent is the exclusive apportionment which the firm can claim if more than half of the research occurred in the U.S. The remainder is divided according to the fraction of foreign sales.

Figure 3
APPORTIONMENT UNDER REGULATION 1.861-8:
SALES METHOD



The *gross to gross method* used the weightings of foreign and domestic gross income. This method is shown in Figure 4. Here, the left column depicts gross income, while the right column remains the domestic R&D expenditures. The R&D deduction is simply divided into domestic and foreign components according to the ratio of foreign income to total income.⁴

⁴Numerically, for a \$100 R&D undertaken in the U.S., suppose a company has 40 percent of sales receipts from overseas and 10 percent of income from overseas.

By the first method, if more than half of the research budget was in the United States

Exclusive Apportionment ¹	\$30
Remainder.....	70
U.S. portion (6 x 70).....	42
Foreign portion (4 x 70).....	28
Total U.S. deduction.....	30 + 42 = 72
Total foreign deduction.....	0 + 28 = 28

By the second method

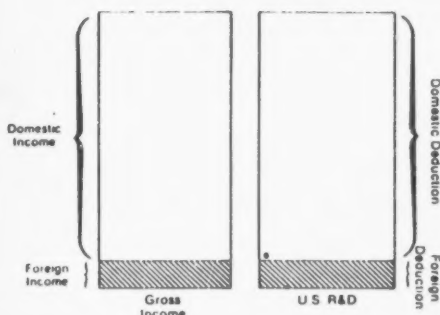
U.S. deduction.....	\$90
Foreign deduction.....	10

In this example, the company would employ the gross income method since it yields a higher domestic deduction. See footnote six for a continuation of this example.

The second method measured "foreign gross income" as the amount repatriated to the U.S. parent corporation. An important consequence was that an international company could retain income in the foreign subsidiary, and thereby increase their U.S. deduction for R&D. This second method biased the deduction in favor of the domestic firm.⁸ As a result, if the foreign deduction under the gross-to-gross method was less than half of that under the sales method, an intermediate method was to be employed. Half of the deduction from the sales method would be the foreign basic deduction, and the remainder would be split according to the relative gross income weightings. This intermediate method is depicted in Figure 5.⁹

Figure 4

APPORTIONMENT UNDER REGULATION 1.861-8: GROSS TO GROSS INCOME METHOD



On the whole, the SIC categories were still considered too broad. Most research was considered to be more narrowly focused than was reflected by the SIC divisions.⁷ With narrower subdivisions, this problem would be reduced.

⁷See the second half of footnote seven, *infra*.

⁸Note that in our numerical example defined in footnote four, the "gross income" foreign deduction was indeed less than half of the "sales" foreign deduction. Therefore, the firm would have to employ the intermediate method in calculating the foreign deduction. This apportionment plan yields:

Half the foreign sales	\$14.00
Remainder	86.00
U.S. portion (9 x 86)	77.40
Foreign portion (1 x 86)	8.60
Total U.S. deduction	\$77.40
Total foreign deduction	22.60

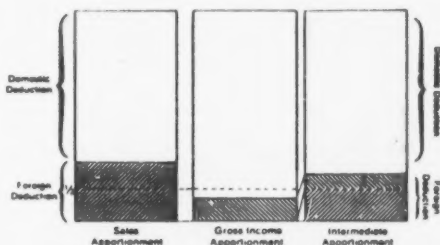
In using the intermediate method, the U.S. deduction will always lie between the sales method and the more lucrative gross income method.

⁹An example of this problem is explained by Ott (1982) in the SIC category 35 (machinery, except electrical). A company is doing research in small gasoline engines for domestic sales; it also markets bulldozers internationally. In calculating the R&D deduction, it would be forced to apportion the credit against the combined engine and bulldozer sales.

(Footnote 7 continued on next column)

Figure 5

APPORTIONMENT UNDER REGULATION 1.861-8: INTERMEDIATE METHOD



In 1981, measures were introduced both in the House and in the Senate to repeal the 1977 regulation (H.R. 2473 and S. 1410, respectively).¹⁰ The intent of these two bills was different from that of the 1977 measure. The sponsors argued that the regulation penalized the foreign tax credit, encouraged existing international corporations to relocate a portion of their research abroad, and discouraged technology-intensive firms from entering export markets.¹¹ While still seeking to address the problem of unrelated foreign income, the proponents also argued that there would be social benefits from increased domestic R&D. They perceived that gains in high technology would provide advantages to the U.S. economy. These benefits could be "purchased" by allowing tax advantages. New York City tax attorney Charles I. Kingson (1981) characterized the situation as a contest among nations for research facilities and revenues.¹²

The 1981 bills were later incorporated into the Economic Recovery Tax Act of 1981. The House version repealed the regulation entirely, while the Senate plan provided a one-year suspension and required a report on the effects of the proposal from the Treasury Department during the interim. The final compromise lengthened the suspension to two years and called for a Treasury report assessing the proposal. (Release of the required report is expected in early June 1983.)

In 1983, with the end of the moratorium approaching, proposals have been introduced in both chambers of the Congress to block the regulation permanently. In the House, Ways and Means Committee member Cecil Heftel, D-Hawaii, has sponsored H.R. 1887, while in the Senate, Finance Committee member Malcolm Wallop, R-Wyo., has joined with ten other senators in proposing S. 654.¹³ As

(Footnote 7 continued)

Similarly a company which does research for foreign sales of gasoline engines and markets bulldozers domestically could skew the deduction towards domestic income. However, under the rules regarding aggregation of SIC categories, it would not matter if the domestic product were in the same category.

¹⁰Keith T. Ott, (1982), p. 900 p. 895.

¹¹Ott, (1982) p. 895.

¹²Charles I. Kingson, (1981), p. 1233.

¹³Tax Notes, March 28, 1983, p. 942. The other senators are William L. Armstrong (R-Colo.), David L. Boren (D-Okla.), John H. Chafee (R-R.I.), John C. Danforth (R-Mo.), Dave Durenberger (R-Minn.), John Heinz (R-Pa.), Bob Packwood (R-Ore.), William V. Roth, Jr. (R-Del.), and Steven D. Symms (R-Idaho). All are members of the Senate Finance Committee.

in 1981, the bills seek both to provide greater equity, in light of the foreign credit limit, and to provide greater benefits for the American economy:

This legislation will...bring our Tax Code into line with the international treatment of domestic research and development expenses, and will help to restore our competitive position in the international marketplace.¹²

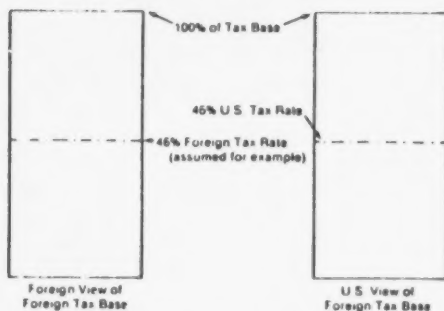
III. Foreign Tax Credits and Their Limitation

To prevent double taxation, the foreign tax credit permits the taxpayer to credit foreign income taxes against his U.S. tax bill.¹³ The foreign tax credits, however, cannot exceed the level of the U.S. tax liability.¹⁴ Accordingly, a formula limits the deduction to:

$$(1) \text{ U.S. limit} = \text{Gross U.S. tax rate} \times \text{foreign taxable income}$$

This result is pictured in Figure 6. In this illustration, the column on the left is the foreign view of the foreign tax base, while that on the right is the U.S. perception. In this example, both nations concur on the tax base and both nations impose the same tax rate.

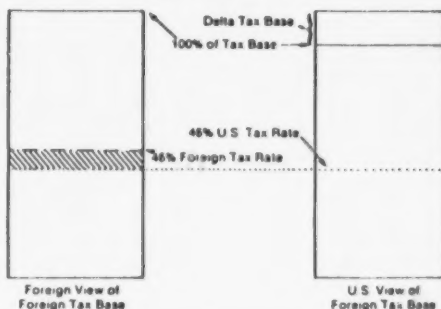
Figure 6
U.S. FOREIGN TAX CREDIT



This calculation breaks down, however, when the U.S. and the foreign government disagree on the foreign tax base. If the U.S. allocates a deduction that the foreign

government does not allow, "foreign taxable income" in equation (1) is lowered, and thus the credit limitation is lowered. The actual foreign tax paid remains unchanged. Specifically, although the U.S. applies deductions based on the U.S. R&D expenses against foreign income, no other nation recognizes those deductions.¹⁵ This result is pictured in Figure 7. The two columns are the same from Figure 6. The area 'delta tax base' represents deductions which are set unilaterally by the U.S. The excess credits are portrayed by the shaded region in Figure 7. The actual foreign tax, which has remained unchanged from Figure 6, now creates excess credits. Unless tax credit carryovers can be utilized, the company would be forced to forfeit those credits.¹⁶

Figure 7
U.S. FOREIGN TAX CREDIT



A company can reduce this loss by physically relocating its R&D in the foreign country. Through this maneuver, the R&D will be counted by the foreign country against the foreign taxes.

¹²Rep. Cecil Heftel, *Congressional Record*, March 2, 1983.

¹³If a company earned \$100 income overseas, a foreign tax rate of 40 percent would reduce this profit to \$60. If the U.S. tax rate of 46 percent were to be applied directly to this remainder, the after-tax profits would be \$32.40—an effective tax rate of 67.6 percent. For compatibility with a similar \$100 of U.S. income, the foreign tax is credited against the U.S. tax, reducing U.S. receipts to \$6. This system sets an effective, and consistent, tax rate of 46 percent of all sources of income.

¹⁴This limitation prevents the foreign government from setting its taxes arbitrarily high. A foreign tax rate of 80 percent in the previous example would result in a \$34 rebate by the U.S. to the American firm. The firm would not feel impaired by this prohibitive tax rate, and the foreign coffers would receive indirect transfers from the U.S. Treasury.

¹⁵George Carlson (1981), pp. 40-46. There is one exception in Canada, which allows deductions for foreign scientific expenditures but not foreign capital expenses.

¹⁶This result can be derived analytically. The original foreign tax is set as:

$$(2) \text{ Foreign tax} = \text{Foreign rate} \times \text{foreign base}$$

The upper bound on the U.S. foreign tax credit (including the American R&D deductions) is:

$$(3) \text{ Credit limit} = \text{U.S. rate} \times (\text{foreign base} - \text{delta base})$$

The foreign tax payments which exceed the limit are calculated by subtracting equation (3) from equation (2). The lost excess credits are then equal to:

$$(4) \text{ Excess credits} = \text{U.S. rate} \times \text{delta base} - \text{foreign base} \times (\text{U.S. rate} - \text{foreign rate})$$

Furthermore, if the U.S. tax rate is equal to the foreign tax rate, as it is in Figure 7, equation (4) reduces to:

$$(5) \text{ Excess credits} = \text{U.S. rate} \times \text{delta base}$$

IV. Model

To illustrate the corporate response to the reestablishment of Regulation 1.861-8, this article analyzes the change in the distribution of domestic and foreign research sites.

Two other approaches to estimating the effects of the section 1.861-8 regulations appear superior in theory, yet are far less feasible in practice. The first choice would have been to balance the social gain in tax revenue from re adoption of the regulations against the social loss from an alteration in R&D expenditures. Evaluating social costs and benefits, however, is an extremely problematic exercise.

This article focuses on...transfers of R&D activities to foreign countries, to illustrate the likely effects of re adoption of the section 1.861-8 regulations.

A second choice, in lieu of the first line of inquiry, would have been to measure the actual change in corporate R&D activity. It is commonly recognized, however, that the corporate response to tax incentives is often considerably delayed. This lag precludes the measurement of actual responses to the 1981 moratorium. Mansfield (1982) notes that other methods must be used to assess the merits of the moratorium. The present article focuses on one particular form of corporate response, transfers of R&D activities to foreign countries, to illustrate the likely effects of re adoption of the section 1.861-8 regulations.

Assume that a company determines its tax on operations in a single foreign country within a single SIC category. Further assume that the company seeks to maximize after-tax profits while holding the R&D budget constant. The company achieves this goal by selecting the optimal distribution of research sites between the U.S. and overseas. The model simulates this process by first assuming values for income and sales, and then, for each allocation of the R&D budget between domestic sites and foreign sites, computing domestic and foreign taxes. Finally, plot the locus of after-tax profits, a variable that is dependent on the percentage of research at the foreign site.

In addition, this computation assumes constant returns to scale and constant costs for research undertaken at either location. By assuming different starting values, we can calculate the effects of varying the foreign tax rates or of changing the ratio of the R&D budget to gross income and sales.

In one model, we assume that the quality of research is the same in both locations. In a second model, we relax this assumption to examine the possibility of a different quality for foreign research. The foreign "quality level" is normalized against the American level and expressed as a percentage. These values are not a judgment that foreign research is inferior, but is intended to reflect the problems of communication and experience that a U.S. firm might undergo in its foreign R&D operations. Thus, if \$100 were spent in a climate that was weighted as 50 percent effective, the real value of that research would be \$50.

In selecting R&D sites, the hypothetical company holds constant the effective value of research. Thus, the tax advantages of foreign research are balanced against the need for higher levels of R&D spending. In neither model is the level of foreign source income affected by changes in the foreign R&D expenditures.

The following table illustrates the first or basic model for the tax apportionment.¹⁷

Table 1
BASIC TAX APPORTIONMENT MODEL

	U.S.	Foreign	Worldwide
1. Sales Percentage	_____	_____	_____
2. R&D Total	_____	_____	_____
3. R&D Quality	_____	_____	_____
4. Nominal R&D	_____	_____	_____
5. Gross Income	_____	_____	_____
6. Sales, Exclusive	_____	_____	_____
7. Remainder	_____	_____	_____
8. Total	_____	_____	_____
9. Gross to Gross	_____	_____	_____
10. Preferred Method	_____	_____	_____
11. Taxable Income	_____	_____	_____
12. Gross U.S. Taxes	_____	_____	_____
13. Max. Tax Credit	_____	_____	_____
14. Actual Foreign Tax	_____	_____	_____
15. U.S. Liability	_____	_____	_____
16. Worldwide Tax	_____	_____	_____
17. Worldwide Tax Rate	_____	_____	_____
18. After-Tax Income	_____	_____	_____

The first line shows the percentage of total sales in the U.S. and the foreign country. The second row shows the effective value of the R&D. This worldwide total will remain fixed while the model transfers R&D from the U.S. to overseas. "R&D quality" is the measure of the effectiveness of the foreign R&D. In the first model, the foreign index is 100 percent, so foreign research is considered as effective as domestic research. The second model varies this "foreign quality" factor. The fourth line is the nominal cost of the R&D. If a \$50 effective value is desired in a 50 percent quality environment, the nominal cost would be \$100.

Gross income is the pre-tax income-sales revenue minus costs, not including the U.S. deduction for R&D. The foreign R&D expenditures are automatically subtracted from foreign income. When the nominal cost of the foreign R&D varies, the difference will be charged to the foreign income.

Lines six through ten of Table 1 apply the allocation methods provided by Treasury Regulation 1.861-8. The first three lines of this section comprise the sales method. The following line depicts the gross income method. Line ten selects the option which maximizes the domestic deduction. If necessary, it invokes the intermediate calculation.¹⁸

¹⁷This example was presented by Mai Nguyen Woo in "Research and Development at Home or Abroad? The Economics of IRS Regulations 1.861-8," a report from the Institute for Research on the Economics of Taxation.

¹⁸See footnotes four and six, *supra*, and text, *infra*, for a description of these methods.

Line 11 contains the tax bases which the U.S. Treasury regards as valid, while the two subsequent lines display the resultant worldwide U.S. tax and the U.S. foreign tax credit limit, respectively. Line 14 shows the actual U.S. credit and the actual foreign tax. The actual credit is the lesser of the foreign tax or the foreign tax credit limit. The next amount is the actual U.S. tax due after subtracting the foreign tax credit.

The worldwide tax is the sum of the foreign tax and the domestic tax; the worldwide tax rate is the ratio of the total tax to the corporate income (gross income less the R&D expenditures). Finally, the worldwide income after all taxes is shown on line 18.

The values for sales, income, R&D expenditures, and R&D relative qualities can be varied. In the first model, the R&D expenditures are varied by location; in the second model, an additional degree of freedom is permitted in the R&D quality.

V. Results

By running the model through each combination of the R&D sites in the U.S. and the foreign country, we can depict graphically in Figures 8 through 14 the after-tax income that results for each permutation. We then assume that the corporate R&D location decision is based upon maximizing this after-tax income.

The two variable elements in these figures are the foreign tax rate and foreign quality of research. Both prove to be quite important in the ultimate corporate decision. Varying the foreign tax rate changes the potential for creating excess credits, that is, a lower foreign tax rate permits more R&D to remain in the U.S. without generating the excess credits shown in Figure 7.¹⁸

Readoption of section 1.861-8 of the regulations will exert pressure to decrease United States R&D.

Since this scenario was developed as a numerical example, the interaction between the tax rates and R&D expenditures implies that any numerical answers are a function of spending and income levels. Thus, if the total income were at a higher level, while the R&D remained fixed, a greater portion of the R&D expenses would have to be sited in a foreign country.¹⁹ All numerical values should not be used directly, but should be examined in relation to the other values to visualize the trends. The actual numbers which were used in this model are listed in Appendix 2.

Figure 8 shows the initial scenario of a foreign tax rate equal to that of the U.S. and a foreign R&D quality which is also comparable. The increasing level of after-tax income arises from the corporate recovery of the excess credits.

¹⁸See footnote sixteen, *supra*, for the more rigorous definition of excess credits.

¹⁹This problem could be eliminated by couching the entire problem in terms of non-dimensional parameters, such as the ratio between the R&D budget and the gross income. That step was outside the realm of feasibility for this work. It remains a logical extension of the work initiated in this paper.

As the R&D moves from the U.S. to the foreign country, it moves from a location where it is only unilaterally recognized as a tax deduction to one where it is mutually recognized as a valid deduction. The discontinuity in the rise of the after-tax income is due to the loss of the exclusive apportionment when the nominal level of R&D passes over fifty percent. After-tax income is highest in this example when 100 percent of the research is undertaken overseas.

Figure 8

AFTER-TAX INCOME WITH INCREASING FOREIGN R&D

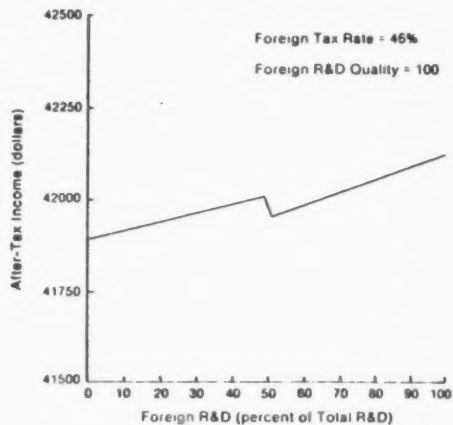


Figure 9

EFFECTIVE GLOBAL TAX RATE WITH INCREASING FOREIGN R&D

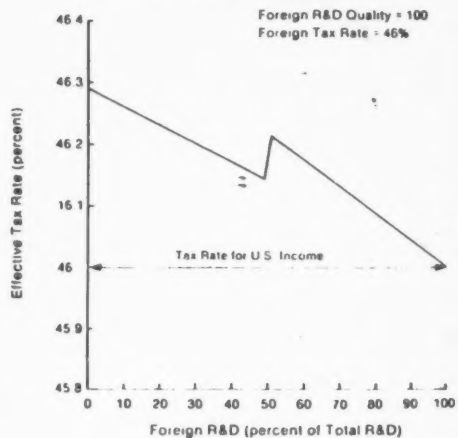
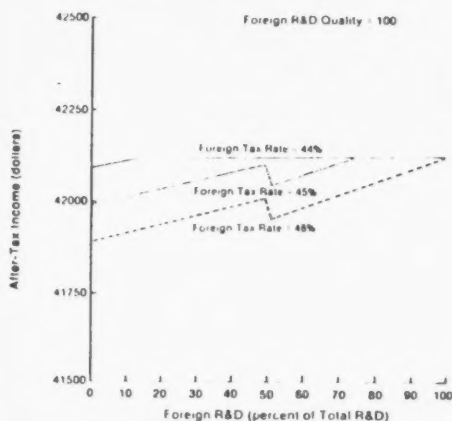


Figure 9 illustrates the complementary effect on the worldwide effective corporate tax rate. This graph is the inverse of the preceding figure, as the excess credits are reduced, the double taxation of those excess credits is eliminated. Consistency in the treatment of foreign earnings and domestic earnings is improved, because R&D deductions are allowed under both domestic and foreign tax rules. Note how the effective tax rate drops to the rate originally proscribed in the U.S. The implication is that regulation section 1.861-8 creates an environment which distorts the choice between domestic and foreign R&D; the tax rate for worldwide income is dependent upon the amount of foreign R&D and income.

Figure 10 depicts the effect of varying the foreign tax rate. Note that as the foreign tax rate drops, the differential between the U.S. rate and the foreign rate alleviates the pressure of the excess credit. Fewer R&D expenditures must be sited in the foreign country to counter the U.S. credit limit.

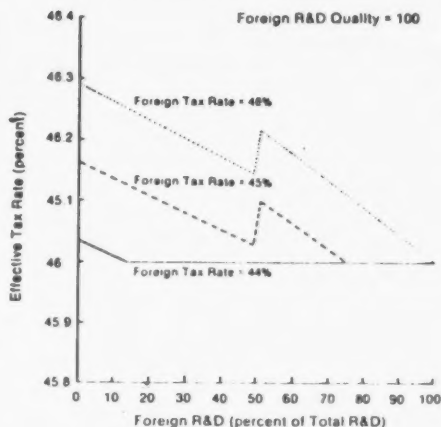
Figure 10
AFTER-TAX INCOME WITH INCREASING FOREIGN R&D



Varying foreign tax rates has a predictable result when examining effective world-wide tax rates. Figure 11 shows that as the excess credits are eliminated at lower foreign tax rates, less R&D needs to be transferred to eliminate the excess credits. In this case, relocating 15 percent of the total R&D suffices to make the U.S. foreign tax credit limit inapplicable when the foreign tax rate is 44 percent, and approximately 70 percent at a foreign tax rate of 45 percent. As excess credits are eliminated, the effective tax rate drops to the common level of 46 percent, the same as would be expected for U.S. income.

The first model tells us that in maximizing corporate after-tax income, U.S. firms will react to Treasury Regulation 1.861-8 by relocating their R&D centers overseas. This move is to combat the creation of excess credits implicit in enforcement of the regulation. The magnitude of the shift depends upon the tax rate in the foreign country. Assuming that a firm would prefer to do research

Figure 11
EFFECTIVE GLOBAL TAX RATE WITH INCREASING FOREIGN R&D



in the U.S., *ceteris paribus*, less R&D would be transferred to countries in which the tax rate - and by implication the potential for excess credits - is lower.

The second model introduces a new factor, the quality of the foreign work. When the foreign quality of R&D is reduced, the tax saving arising from relocation is offset. This effect can overwhelm the initial trend toward relocation overseas. The monies saved through manipulation of the tax code are lost due to inability to recoup the full value of foreign R&D expenditures.

The regulation creates problems for firms planning to enter export markets.

Figure 12 depicts three levels of "foreign quality" - 100, 90, and 75 - where 100 is the U.S. standard. At the 75 mark (where foreign research is only three-quarters as effective as that in the U.S.), the optimum corporate decision is to retain all of the R&D outlays in the United States and not to venture overseas.

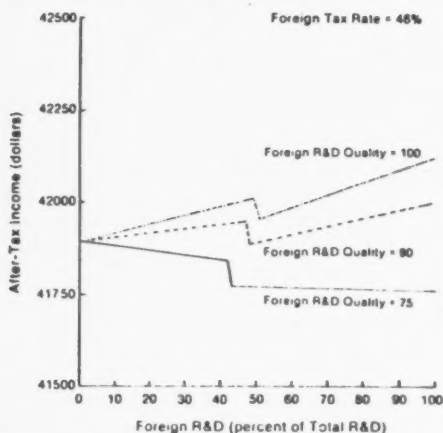
This effect is even more pronounced when the foreign tax rate is lowered. The inefficiencies of utilizing foreign R&D continue unabated, while less countervailing tax savings accrue. This situation is displayed in Figures 13 and 14 for foreign tax rates of 45 percent and 44 percent, respectively. These rates were selected from the previous example. Note that the 100 level in the last three figures is identical to the respective traces in Figure 10.

VI. Limitations

Several objections can be raised to the assumptions used in this model. The model does not include a changing

marginal value for research. There might be high start-up costs, so that the marginal costs of foreign R&D may fall. The marginal rates might not be fixed at one level, but might rise (or fall) with further expansion of foreign R&D. The marginal cost of foreign research should be greater at higher levels and at the starting levels. At the upper end, the decreasing marginal benefit of research work, as greater amounts of the foreign pool of research are used, should act to lower the quality of the research.

Figure 12
AFTER-TAX INCOME WITH
INCREASING FOREIGN R&D



At the outset, foreign research would be difficult as well. In a study on the transfer of domestic research to foreign sites, Benvnigali (1981) pointed out that experienced multinational companies were able to transfer work more swiftly than inexperienced firms. Benvnigali noted that a major impediment was simply the exchange and clarification of information.²¹

Since the quality of the foreign research is measured against the American level, an improvement in the U.S. quality would adversely affect the value of the foreign research. As the U.S. level declined, presumably the lesser quality centers would be the first to be dropped, leaving a core of higher U.S. quality.²²

Neither the marginal cost challenge nor the marginal benefit challenge is strong if the changes in research reflect only small changes in the overall pool of research in

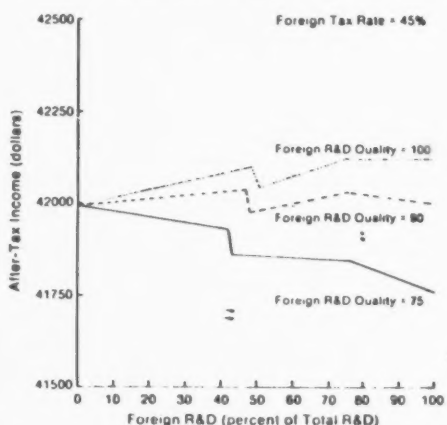
either domestic or foreign locations. On the other hand, since many companies would feel these pressures on their R&D efforts, the total change in either research pool could be quite significant. In either event, the start-up problem would continue to vex new participants in overseas research. This event can be adequately simulated by examining a case with low foreign quality. This approach, however, solely models "short-sighted" companies since it only explores their transient costs.

Also open to discussion are the mechanisms by which firms adjust to the reimposition of the section 1.861-8 regulations. We assumed here that they retain constant levels of gross income and overall research expenditures. More realistically, a company might simply re-evaluate its R&D spending based upon the higher cost of research and development—a question of the elasticity of demand for R&D.²³ Alternately, a company might juggle the retained earnings of the foreign company rather than altering the R&D performed by that company. This paper seeks to expose the forces for relocating R&D generated by reimposition of Regulation 1.861-8. Holding these other means of adjustment constant permits this pressure to be examined.

VII. Conclusions

With these limitations to the model acknowledged, several conclusions remain clear. Re-adoption of section 1.861-8 of the regulations will exert pressure to decrease United States R&D. In addition, the regulation creates problems for firms planning to enter export markets.

Figure 13
AFTER-TAX INCOME WITH
INCREASING FOREIGN R&D



Whether the corporate response is of the type postulated in this paper, or takes the form of a reduction of the overall R&D budget, the regulation impedes American R&D. In

²¹Anita Benvnigali, (1981), p. 500.

²²This effect on the foreign quality can be approximated by

$$\frac{\text{Foreign quality}}{\text{U.S. quality}} = \frac{1}{(1+Q)} = \frac{(1-Q)}{1}$$

"Q" represents the increase in American quality. This approximation is valid for small values of Q.

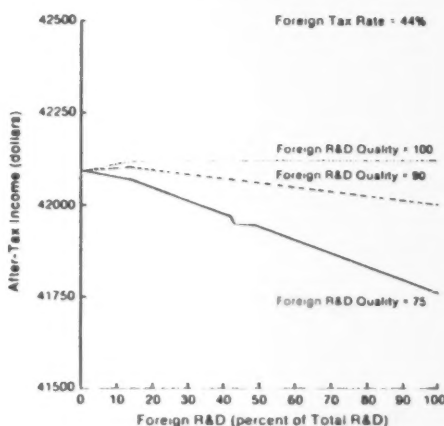
²³Telephone interview with Harry Grubert, Treasury Department, April 4, 1983.

addition, the mechanism in this regulation hobbles international firms with a tax rate that is high in comparison with those firms that are located solely in the U.S. As Figure 9 demonstrates, the corporate tax rate for international firms is higher than the rate for firms that have U.S. income only.

The obverse of the comparability debate is that R&D completed in the U.S. frequently generates foreign income and the deduction for those expenses should therefore be allocated against the foreign tax base. The tax codes in foreign lands create an externality (unilateral R&D deductions) which renders this argument less valid. Short of changing the practices of the foreign nations, the second-best solution for eliminating this externality is to adopt a similar tax stance in the U.S. international tax codes and not to force the U.S. firms to apply unilaterally deductions which are not recognized in foreign tax systems.

Figure 14

AFTER-TAX INCOME WITH INCREASING FOREIGN R&D



Another repercussion can be seen in the realm of export markets. The U.S. is currently engaged in several attempts to facilitate American exports. In practice, however, this regulation counteracts those efforts. Consider, for instance, a domestic firm with large R&D expenditures: a timely example is a technologically intensive firm, a type which the U.S. is also currently seeking to cultivate. When a domestic firm of this type attempts to enter the foreign market, it will be penalized by this regulation, for it initially possesses no foreign R&D facilities. In addition, it will be less able to develop these sites, for as Benvignati (1981) points out, internationally inexperienced firms have a more difficult time adjusting initially. This would correspond to lowering the quality of the foreign R&D (for the firm is less able to make use of the research). Figures 12 through 14 clearly illustrate that, given this inefficiency, a firm might well decide not to develop foreign sites at all.

Thus, newly entering firms are pinned between the requirements of the regulation and their own inexperience.

These repercussions all indicate that readoption of Regulation 1.861-8 would undercut other American economic initiatives. The fundamental problem is not the definition of industrial categories, or the reduction in "unrelated foreign income." Instead, the problem is that deductions for domestic expenses are set against foreign income. To enhance the American international trade sector and provide comparability between the tax treatment of foreign and domestic income, the moratorium on section 1.861-8 of the regulations should be continued.

APPENDIX 1

Standard Industrial Code Categories

- (01, 02, 07, 08, 09) Agriculture, forestry, and fisheries
- (10, 11, 12) Hard mineral mining
- (13) Crude petroleum, and natural gas
- (14) Nonmetallic minerals
- (15, 16, 17) Construction services
- (20) Food and kindred products
- (21) Tobacco manufacturers
- (22) Textile mill products
- (23) Apparel and other finished products made from fabrics and similar materials
- (24) Lumber and wood products, except furniture
- (25) Furniture and fixtures
- (26) Paper and allied products
- (27) Printing, publishing, and allied industries
- (28) Chemicals and allied products
- (29) Petroleum refining and related industries
- (30) Rubber and miscellaneous plastics products
- (31) Leather and leather products
- (32) Stone, clay, glass, and concrete products
- (33) Primary metal industries
- (34) Fabricated metal products, except machinery and transportation equipment
- (35) Machinery, except electrical
- (36) Electrical and electronic machinery, equipment, and supplies
- (37) Transportation equipment
- (38) Measuring, analyzing, and controlling instruments, photographic, medical, and optical goods, watches and clocks
- (39) Miscellaneous manufacturing industries
- (40, 41, 42, 43, 44, 45, 46, 47) Transportation services
- (48) Communication
- (49) Electric, gas, and sanitary services
- (50, 51) Wholesale trade (not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories and not applicable with respect to a domestic international sales corporation for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories)
- (52, 53, 54, 55, 56, 57, 58, 59) Retail trade (not applicable with respect to sales by the taxpayer of goods and services from any other of the taxpayer's product categories, except Wholesale trade, and not applicable with respect to a domestic international sales corporation for which the taxpayer is a related supplier of goods and services from any other of the taxpayer's product categories, except Wholesale trade)
- (60, 61, 62, 63, 64, 65, 66, 67) Finance, insurance and real estate
- (70, 72, 73, 75, 76, 78, 79, 80, 81, 82, 83, 84, 86, 88, 89) Other services

APPENDIX 2

Actual Figures Used in Preparing the Model*

	U.S.	Foreign	Worldwide
1. Sales Percentage	60	40	100
2. R and D Total	2000	0	2000
3. R and D Quality	100	100	0
4. Nominal R and D	2000	0	2000
5. Gross Income	70000	10000	80000
6. Sales Exclusive	600	0	600
7. Remainder	840	560	1400
8. Total	1440	560	2000
9. Gross to Gross	1750	250	2000
10. Preferred Method	1505	495	2000
11. Taxable Income	68495	9505	78000
12. Gross U.S. Taxes			35880
13. Max. Tax Credit		4372	
14. Actual Foreign Tax	4372	4600	
15. U.S. Liability	31508		
16. Worldwide Tax			36108
17. Worldwide Tax Rate			46.29
18. After-Tax Income			41892

*In this particular example, the foreign tax rate is 46 percent and the foreign R&D quality is 100 percent. This corresponds to Figure 8 where the foreign R&D percentage is 0 percent of the total R&D.

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Chairman RANGEL. Thank you, Mr. Heftel. Your full statement will appear in the record.

Why is it that you would not take an approach that would benefit all domestic corporations by providing tax incentives for research and development here in the United States rather than to target the 24 multinationals? Why can't you stick closer to an equitable distribution of expenses as relates to United States and foreign source income and at the same time get at the problem, which you correctly have identified, that is not only to make us competitive with manufacturers abroad, but also to be certain our smaller companies have an opportunity to be competitive with the multinationals?

Mr. HEFTEL. But the two don't interact, Mr. Chairman.

No matter what you decide, or what you want to do for the smaller companies—and there are proposals which I have certainly supported to encourage R&D in the purest sense—regardless of how you treat that question, you still have the question of where are the multinationals going to place their R&D?

Nothing that you do to encourage domestic small companies in R&D will change the decision of where the so-called multinationals places their R&D.

Chairman RANGEL. But under the moratorium, we are operating under the fear that if we change it, and have a different allocation, that for profit motivation rather than patriotism—which certainly the board of directors would be concerned with the profit—that domestic R&D would be displaced with foreign R&D.

My question is, Mr. Heftel, why not take the quarter million or whatever the revenue shortfalls are, and rather than risk and speculate what the multinationals would or wouldn't do, just provide the incentive for what they do actually do in research and development in the United States of America?

Instead of seeing what revenues we lose, why not make a direct grant or give the tax credit to those that expand their research and development in the United States?

Mr. HEFTEL. But, Mr. Chairman, we can expand existing R&D tax credits if we want to. I cannot guarantee to you, however, that that will produce more domestic R&D.

But we already have in place credits to encourage R&D.

Chairman RANGEL. I am just saying that—

Mr. HEFTEL. That doesn't really—

Chairman RANGEL. Your testimony is, I think, that if we don't take action to reduce their tax liability we would have reason to believe that many of the multinational corporations would opt to carry their operations overseas. My only question is, if it is reduction in tax liability that would motivate them to do this, why not give the credits to encourage them to stay and expand here rather than to enter into a false concept that expenses shouldn't be allocated even though it is a part of doing business overseas?

Mr. HEFTEL. Well, we are competing in a world of 10 or 12 potential economically oriented countries. None of those countries requires allocation of R&D expenditures to foreign source income as we do.

Now, the reason for that is that they want to encourage from all sources R&D to take place in their countries.

Now, we put ourselves at a disadvantage with every one of those countries because every one of them has been smart enough to know that if there is a disincentive to do R&D in their country and an economic advantage to do it in another major country—the United States, for example—that they will lose R&D.

To the extent that what competitors are doing tells us something about where the benefits are derived, we should take a look at those factors.

Now, Mr. Chairman, at no time is a multinational going to conduct domestic R&D when there is an economic advantage because of tax policy to doing that same R&D in a foreign country. That is why our foreign R&D is growing faster than our domestic.

You can't change the fact that there are multinationals and you can't change the fact that they will have 70 or 80 percent of the R&D affected by section 861. Simply, their size dictates that that will be the case.

You want them to do that R&D in the United States, not in a foreign country, but our tax policy is so constructed that they gain from doing it in a foreign country. Now, you could pass a law and say you can't export R&D, but it seems to me that that would not be the approach to use.

This seems to be the approach to use.

Chairman RANGEL. I was not talking about the sanction. I certainly was talking about special legislation. Even though this sounds like it has broad universal implications, you are suggesting that the beneficiaries of this legislation you propose will be 20 corporations.

I am saying if we deal with special legislation, let's do it and provide the incentives and the carrot, rather than the sanctions and the stick to encourage them to keep and expand their R&D here.

It just sometimes annoys me. Even though I am against loopholes and I support incentives when I support the objectives—we all do that—it just seems to me if we deal with special legislation that the committee ought to do it and encourage the corporations to continue their fine work in R&D without allowing the American people to believe that we are just having broad economic policies, when it, in fact, doesn't really apply to most industries.

It just applies to 20 or 25 corporations. How did you first feel the impact of the export in Hawaii?

Mr. HEFTEL. I didn't feel it. It doesn't affect Hawaii.

In trying to find out why we were losing our position in the growth of productivity, why we were slipping from first to 3d to 7th to 10th, one of the factors that comes up the minute you start from that perspective is the disincentive in the tax policy for these multinationals you describe to do their R&D in the United States.

Once they do their R&D in foreign countries, the licensing and production then occur in the foreign countries and that, to me, is not desirable. The fact that they are multinationals and they are large is not something that you or I or anyone else can do anything about.

The fact remains, though, that because they are multinationals and because they are large, they will do a preponderance of the R&D. That R&D will be done in the United States if there is no disincentive.

It will be done in foreign countries if there is. At the present time with a great deal of uncertainty involved, the rate of growth has been faster in the foreign countries than in the United States.

The reason is very simple. Dollars and cents to the multinationals is the reason.

What is the economic impact on the United States when the R&D is exported? I think it is self-evident.

What is the reason given? The one that you come up with immediately upon asking is we are penalized tax-wise if we do R&D in the United States.

Chairman RANGEL. What kind of corporations or multinationals do you think we are talking about?

Mr. HEFTEL. All of your large industrial conglomerates, whether it is Eaton, TRW, on through the list, which I just don't keep in mind, but they are easily identified. To the extent that they gain from placing their R&D in a foreign country, they are going to do so.

Now, we may not like it. Perhaps we find it offensive. But the fact remains that they deal strictly in their bottom line and that bottom line is not our bottom line.

To the extent that they place that R&D in a foreign country, we ultimately lose the licensing that goes with it and whatever incentives we use, however we establish them, they have to deal with that problem because it is the real one.

Other foreign countries have recognized the same thing. As a result, other foreign countries have not elected to follow our theory that you can only take that portion which applies to your domestic sales.

They allow them to take it for all of their sales on the theory that they want the R&D and they want the production and licensing in their country.

Chairman RANGEL. Let me thank you for the contribution that you have always made to the committee and certainly in bringing understanding to this problem to me and other members of the subcommittee.

We are glad that you are back to help us wrestle with finding an equitable solution that will be fair to our business people and certainly keep them competitive with foreign nationals.

Thank you so much.

Mr. HEFTEL. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Martin is here.

Mr. MARTIN. I want to join in welcoming our colleague back.

Mr. HEFTEL. Thank you. I am delighted to be back.

Mr. MARTIN. Thank you.

Chairman RANGEL. We have a panel now that will be called, the Chamber of Commerce, C. William Schick, assistant controller, United Technologies Corp., accompanied by David E. Franasiak, manager of tax policy; National Association of Manufacturers, Robert A. Ragland, director of taxation; Peter McCloskey of the Electronic Industries Association, accompanied by Richard Irwin; and Robert McNeill, Emergency Committee for American Trade.

Thank you, gentlemen, for agreeing to share your views with us today.

We know what the question is that we are wrestling with. With unanimous consent of the committee, your full prepared statements will be entered into the record.

It would be helpful if you could use the 5 minutes that we have allocated to you to try to answer some of the questions that have been raised by those people that oppose the extension of the moratorium.

Let's hear from the Chamber of Commerce, Mr. Schick.

STATEMENT OF C. WILLIAM SCHICK, ASSISTANT CONTROLLER, UNITED TECHNOLOGIES CORP., ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY DAVID E. FRANASIAK, MANAGER OF TAX POLICY

Mr. SCHICK. Thank you very much, Mr. Chairman. I will briefly summarize what we think is the correct answer.

The technical and economic aspects have been well covered today. I have several key points.

First, we believe that the 1977 regulations are incorrect. We don't think that a cost allocation system that allocates U.S. R&D costs to foreign source income under circumstances where double taxation can arise must be corrected and must be approached carefully.

It is wrong to require allocation of R&D on bulldozers to income earned for lawn mowers, as the regulations do, just because these two products happen to be in the same S.I.C. classification.

Second, no matter how carefully the cost allocations are made, there is the potential, as has been discussed this morning, that costs will rise for R&D in this country and will have the potential of decreasing the R&D in this country.

It seems that Treasury supports this view. However, they have apparently not addressed the question of whether the allocations in the regulations are correct.

Finally, we think that although there may be other solutions, the simplest solution to this 861 question is to provide that all R&D costs incurred in the United States be allocated to U.S. source income.

It comes closest to what we believe is the correct solution and it removes increased tax costs that may arise from performing of R&D in the United States.

We urge that the provision be made permanent and that an additional 2 year moratorium is not appropriate.

Chairman RANGEL. Thank you, Mr. Schick.

[The prepared statement of Mr. Schick follows:]

STATEMENT OF C. WILLIAM SCHICK, ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

I am William Schick, Assistant Controller of United Technologies Corporation. Our company is a member of the Chamber of Commerce of the United States, which is the organization I represent today. Accompanying me is Mr. David E. Franasiak, the Chamber's Manager of Tax Policy. We appreciate having this opportunity to address important research and development tax policy questions.

United Technologies Corporation designs, develops and manufactures products with high technology content. Our products include Pratt & Whitney Aircraft gas turbine engines, Sikorsky helicopters, Otis elevators, and Carrier air conditioners. We are headquartered in Hartford, Connecticut. Our annual sales volume is 14 bil-

lion dollars. We invest 800 million dollars each year in research and development. We carry out our work with 180,000 employees.

SUMMARY

The U.S. Chamber supports making permanent the two-year rule in Section 223 of the Economic Recovery Tax Act of 1981, which provides that Research and Development (R&D) costs paid and incurred in the United States are to be allocated to U.S. source income. This provision suspended for 1982 and 1983 the R&D portion of Section 1.861-8 of the Income Tax Regulations, issued by Treasury in 1977. The matter now urgently requires attention.

The Internal Revenue Code has provided for a long time that foreign source income must be reduced by an allocation of indirect expenses incurred in the U.S. The 1977 regulations required that certain amounts of R&D costs incurred in the United States be charged against foreign source income. This, in turn, in many cases reduces the foreign tax credit while usually increasing the U.S. tax by an equal amount.

The effect is that substantial amounts of R&D costs incurred in the United States are denied as Federal income tax deductions. The methods of computing the R&D allocations under the regulations are highly arbitrary. Because of that, the expenses are not generally deductible in foreign countries. In these instances, the costs are not deductible anywhere. Another way of saying it is that the same business is, or can be, subjected to double taxation—foreign and U.S.

The 1977 regulations require U.S. R&D incurred to design and develop a domestic product to be allocated to foreign source income derived from sales of the products that have nothing to do with the U.S. products.

Such results are in conflict with sound tax policy. It is wrong to have regulations which result in double taxation. Such results are also in conflict with sound trade policy. One way a company could avoid the 1.861-8 penalty is to transfer R&D operations to countries that would allow a tax deduction.

The Treasury itself, in its study, recognized that the regulations could reduce R&D expenditures in the U.S. and adversely affect our competitive position. On that basis, Treasury recommended a further two-year suspension. We think that Treasury's conclusions justify a permanent solution now.

We understand the Committee wishes to consider the relationship of the Section 861 R&D matter to the "Tax free" transfer of technology abroad for use in manufacturing operations. We think there is a limited relationship between these two matters. The Section 861 matter is largely concerned with tax policy. The question in this matter is whether the allocations of R&D required in the 1977 regulations are correct and whether it is proper to have a provision which results, or can result, in double taxation.

The transfer of technology abroad is largely a trade issue, the tax policy questions having been already dealt with through Section 367(a), which requires taxpayers to obtain rulings from the IRS as to whether tax avoidance is the nature for transfers. The Chamber opposes deterrents to trade, such as taxes on transfers of economic resources between the United States and its trading partners.

OUR VIEWS IN MORE DETAIL

Tax policy aspects

Sections 861, 862, and 863 of the Internal Revenue Code were created to define the source of income. They require that indirect expenses be apportioned to the source of income. Presumably, if this defining process is properly carried out, that which is U.S. source income will be taxed in the U.S., and that which is foreign source income will be taxed in the foreign nation. It is entirely correct to deal with the apportionment of expenses to source in this context.

Since the overall foreign tax credit is limited to 46% of a company's foreign source income, there is a need to define source of income for that purpose. Sections 861, 862, and 863 are used for this purpose. These sections require an apportionment of deductions to the source of income.

The allocation of indirect expenses to the foreign source income, without a corresponding foreign deduction, has the inherent effect of taxing the same earnings twice; that is to say, the allocations cause double taxation. This result, of course, defeats the very purpose of the foreign tax credit, which is to prevent double taxation.

Double taxation results, or can result depending on the particular circumstances, because the U.S. expenses that are allocated under the Section 1.861-8 regulations

to the foreign source income generally are not deductible or may not be deductible in the foreign jurisdiction. This result occurs because the world taxing system is not set up to provide that indirect expenses to be allocated under the Section 1.861-8 concept are deductible in the foreign jurisdiction. Thus, a U.S. taxpayer—in effect—receives no deduction for the expenses either in the U.S. or in the foreign country from which the foreign source income is derived.

Moreover, a U.S. taxpayer can avoid or minimize the penalty imposed by the Section 1.861-8 regulations by moving all or some of its R&D operations to other nations, where a deduction might be realized. In writing the Section 1.861-8 regulations, the Internal Revenue Service misinterpreted, we believe, the intent of Sections 861, 862, and 863 as they relate to the foreign tax credit.

A theoretical example of this process is shown in the Appendix. The example assumes that a U.S. company maintains an operation in foreign Country X, through a foreign subsidiary. The operation in Country X is an exact duplicate of the operation in the U.S. Country X's tax laws are exactly the same as the tax laws of the U.S., except that Country X allows a full deduction for all R&D incurred in Country X. In the example, it is assumed that the U.S. requires a 35 percent allocation of R&D costs, if incurred in the U.S., to foreign source income. Further, the example assumes 100 percent of the income earned in Country X is repatriated.

Using the figures in the example, if the R&D expenses are incurred in the U.S., the effective combined foreign and U.S. tax rate is 54.9 percent even though the tax rate in each country is 46 percent.

If the R&D effort is carried out in Country X instead of in the U.S., the combined rate is 46 percent, exactly equal to the rates imposed in each country.

This example demonstrates how 1.861-8 results in double taxation. It also demonstrates how the regulations result in a denial of an R&D deduction and that this anomaly could be overcome by moving the R&D operations.

The main problem is that the 1977 regulations require the allocation of U.S. R&D to foreign source income almost without regard to any particular facts or circumstances. In the regulation, there is a presumption that U.S.-incurred R&D that is even remotely related to products the taxpayer manufactures abroad must be allocated to income earned abroad.

The overreaching regulatory approach is exemplified in a particular provision in the regulations which requires that R&D spent in the United States to develop bulldozers must be allocated to foreign source income derived by an affiliated manufacturer from sales of lawn mower engines abroad. The regulations require this conclusion on the basis that bulldozers and lawn mower engines are in the same two-digit Standard Industrial Classification (SIC) Code; hence, there is a presumption that bulldozer R&D benefits lawn mower engines.

Whether there is a casual or beneficial relationship between bulldozer R&D and lawn mower engine R&D, we do not know. We suspect there is not much of a relationship. Even if it were correct to allocate any U.S.-incurred R&D expenses to foreign source income for purposes of computing the foreign tax credit, it is wrong to do so in an arbitrary and inflexible manner such as is mandated in the 1977 regulations.

We know of an actual instance where the regulations may require R&D expenses incurred to design and develop a product in the U.S. to be allocated to income derived from a different product developed in a foreign country merely because the two products are in the same SIC. The Department of Commerce has confirmed that the two products are in the same SIC only because separate classifications would cause the public disclosure of competitive information.

The U.S. Department of Commerce publishes product/service classifications for the purpose of compiling industrial statistics. Thus, the classifications may or may not reflect the extent to which a particular R&D project benefits another project. SIC's should not be used for cost allocation purposes.

The regulations also presume that all R&D is conducted in the United States, and completely ignore the fact that many products manufactured and sold abroad were designed and developed abroad. It makes no sense to require allocations of U.S. R&D expenses to income derived from sale of products abroad that were, in fact, designed abroad.

The arbitrariness of those regulations caused the current controversy. This controversy now requires that Congress enact a correct solution.

In those cases where the facts and circumstances do indicate that R&D expenses incurred in the United States are conducted on behalf of a foreign operation, the Commissioner may invoke Section 482. This section gives the Commissioner the power to distribute, allocate, or apportion any deduction to any commonly owned organization or trade or business to which the deduction pertains. If that process is

correctly carried out, each entity, U.S. and foreign, will bear its proper deductions and report its proper income to the relevant taxing authorities, and the current controversy will be resolved.

Relationship to "tax-free" transfers to technology

We do not think there is a significant relationship between the Section 1.861-8 matter and the so-called "tax-free" transfer of technology abroad. The Section 1.861-8 regulations are wrong from a tax-policy viewpoint based on the analysis we have presented above.

The proposed cure to the 1.861-8 problem does have some trade policy aspects since the cure is to provide that all R&D expenses incurred in the United States are to be allocated to U.S. source income. This is also a practical solution, since it is unlikely that detailed, formula-type regulations can be written which will result in a correct allocation. This is because correct allocations depend on the particular facts and circumstances pertaining to the various taxpayers.

On the other hand, the question of transfer of technology abroad is largely a trade issue. At one time, it was a tax policy issue because the possibility existed of transferring technology abroad in order to avoid income taxes. This matter has been dealt with already through Section 367 which mandates that the taxpayer request a ruling, in which proceeding the taxpayer must prove that his purpose is not to avoid U.S. income taxes. Also, Section 1491 deals harshly with tax avoidance, imposing a 35 percent excise tax on transfers made for the purpose of avoiding income tax.

Therefore, the matter is one of trade policy. Is it in the interests of the United States to permit tax-free transfers of resources abroad? Such resources include capital and people, as well as technology. Except in cases where such transfers can endanger the Nation's security, it has been the policy of the United States to not impose barriers on these transfers. The U.S. Chamber continues to support this policy.

Treasury report

Finally, the Treasury Report on the Section 1.861-8 regulations concludes that the regulations do cause a reduction in U.S. R&D activity, and that this, in turn, can cause a loss in our nation's competitiveness. There is a consensus that the American business establishment is falling behind its foreign competitors in productivity. There is little doubt that this trend, in whole or in part, comes about from a decline in the level of U.S. R&D expenditures relative to those of some other countries. We must not allow this trend to continue.

On the other hand, the Treasury study does not fully address the question as to the correctness of the 1977 regulations. The report states, "The objective (of the regulations) is to avoid allocating R&D expense related to one product to foreign source income earned from sales of a wholly different product category." We question whether this is a properly stated objective. Even if it is, the regulations do not achieve the objective because they require allocations of R&D costs to foreign source income earned from wholly different product categories through the use of SIC Codes that were not designed for tax purposes.

We think the regulations are wrong, and unlike the Treasury Department, we recommend not an additional two-year suspension of the R&D portion of the regulations, but a permanent solution. Temporary resolutions do not permit companies to plan how resources are to be deployed. Over the past few years, there has been enough on-again-off-again tax policy. The right solution is to require that U.S. incurred R&D expenditures be charged to U.S. source income.

THEORETICAL MODEL—HOW §1.861-8 REGULATIONS CAN RESULT IN DOUBLE TAXATION

Assumed Facts:

1. Company operates in two countries, through subsidiaries, U.S.A. and Country X.
2. Factory, sales and support operations in the two countries are exact duplicates. There are no exports.
3. Country X's Internal Revenue Code is exactly the same as U.S. Internal Revenue Code, except that all R&D expenses incurred in Country X are allocable to Country X source income.

	Model No. 1—R&D facility in U.S.A.		Model No. 2—R&D facility in country X	
	U.S.A.	Country X	U.S.A.	Country X
Sales	\$1,000	\$1,000	\$1,000	\$1,000
Total cost, excluding R&D	650	650	650	650
R&D costs	250			250
Total costs	900	650	650	900
Income before tax	100	350	350	100
Tax		161		46
Available for distribution		189		54
Distributed	189	189	54	(54)
Gross-up	161		46	
Taxable income	450		450	
Tax-tentative	207		207	
Tax credit	121		46	
Tax	86		161	
Combined tax		247		207

Combined tax rate of two countries: 46 percent times \$450 equals combined tax of \$207—model 2; 54.9 percent times \$450 equals combined tax of \$161—model 1.

COMPUTATION OF TAX CREDIT

Foreign source income:		
Per country X return	350	100
Less assumed § 1.861-1 allocation	88	0
Total	262	100
Limitation—46 percent	121	46
Foreign tax deemed paid	161	46
Loss of credit	40	0

Chairman RANGEL. The National Association of Manufacturers, Mr. Ragland.

STATEMENT OF ROBERT A. RAGLAND, DIRECTOR OF TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. RAGLAND. Thank you very much. I will summarize my statement briefly for the record.

The position of NAM is that the current moratorium on the allocations of R&D costs under IRC section 861 should be made permanent. Continued reliance on ERTA's moratorium enacted on an emergency basis promotes uncertainty in our R&D tax policy and will require us to revisit this question again in future years.

There are two reasons for our position. The first is that the 1981 moratorium in our judgment is working. Notwithstanding the generally unfavorable climate of the past 2 years, industrial R&D increased 10.2 percent since 1981. Before that, spending on research and development generally was declining. In fact, it had fallen

below its 1960 level so that by 1979 it comprised only 2.25 percent of GNP compared to 2.9 percent of GNP in the period 1963 to 1968.

Clearly, the implication is that permitting American companies to allocate R&D expenditures against domestic income in conjunction with other tax incentives such as the 25-percent incremental R&D tax credit establishes a reasonable parity in the tax advantage enjoyed by American companies vis-a-vis those enjoyed by corporations in other major industrialized nations.

The second reason is that Federal tax policy should encourage domestic R&D—not encourage its movement to other countries. American technological advantage is due directly to R&D conducted here.

By insuring conformity in treatment as to our R&D tax advantage, Congress will be promoting those activities here. If this moratorium is permitted to expire, Congress will be encouraging American businessmen to search for locations outside the United States to site their R&D activities.

This movement will do two things. First, technology in the form of the product of research and development activities will be exported, and second, technological capability will be exported.

We have observed that the number of scientists, skilled engineers, and other research personnel employed by the foreign affiliates of multinationals has increased more rapidly than the parent company. The degree to which this effect has been produced by tax regulations rather than by foreign and domestic growth rates can be evidenced by the fact that the rise in the ratio of foreign to total research and development was typically greater than the change in the ratio of foreign to total sales.

In summation, we believe that Federal tax policy should favor domestic research and development, the cornerstone of our technological edge. What is more, our tax laws should insure that the product of American R&D, and the technological ability to conduct these activities should remain here.

Accordingly, we urge you to report favorably proposals making permanent the current moratorium on 861 allocations.

Thank you very much.

Chairman RANGEL. Thank you, Mr. Ragland.

[The prepared statement of Mr. Ragland follows:]

STATEMENT OF ROBERT A. RAGLAND, DIRECTOR OF TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS

I am Robert A. Ragland, Director of Taxation for the National Association of Manufacturers. On behalf of NAM's more than 13,000 member firms who represent 85 percent of the nation's industrial output and 80 percent of its industrial workforce, I am pleased to have this opportunity to present our views on proposals which would rescind, on a permanent basis, that portion of Section 1.861-8 of the Treasury Regulations requiring allocation of domestic research and development (R&D) expenses between U.S. and foreign source income, thus making all such expenses deductible against U.S. income. NAM strongly supports this change.

INTRODUCTION AND SUMMARY

The need for preservation of R&D tax incentives is evidenced by the fact that R&D expenditures in the aggregate underwent a decline during the period 1969-75. The share of Gross National Product (GNP) comprised by R&D is now lower than during its peak levels of the late 1960s. Furthermore, in this respect, the share of GNP comprised by non-military R&D outlays is lower than in most other major in-

dustrial countries. However, since the enactment of the R&D tax provisions¹ of the Economic Recovery Tax Act of 1981 (ERTA), R&D expenditures have exhibited an upward trend, notwithstanding an unfavorable overall economic environment. The implication is that these ERTA provisions have enhanced R&D outlays, suggesting that such provisions should be retained in order to achieve continued increases in R&D in subsequent years.

Section 1.861-8 of the Treasury Regulations, by requiring that U.S. multinational corporations allocate a given share of their R&D expenditures to their foreign affiliates, has tended to depress domestic R&D spending in relation to R&D conducted overseas. Section 1.861-8 also has tended to increase the tax liability of American multinational firms by denying tax benefits for deductions allocated to foreign source income. Provisions comparable to Section 1.861-8 do not exist in the tax codes of other major industrial countries.

THE NEED FOR R&D TAX INCENTIVES

The need to retain tax incentives for R&D Outlays is evidenced by the deterioration of R&D spending during the 1970s. Table 1 (in the Appendix) gives outlays for total and industrial R&D in constant 1972 dollars, and the ratio of total R&D expenditures to GNP.

From roughly 1969 until 1976, there was a sharp decline in total R&D expenditures, which fell substantially below their levels of the late 1960s. In 1960-68, total R&D spending in constant dollars increased 52 percent. Thereafter, there was a small decrease coinciding with the recession of 1969-70. However, during the recovery of 1971-73, R&D spending failed to improve as rapidly as during previous cyclical upswings in the economy, and in 1973 at the peak of the boom, real R&D spending was still below its 1968 level. The recession of 1974-75 led to another contraction in R&D spending. In 1975, at the trough of the recession, R&D outlays were 5.3 percent lower than in 1968. The recovery of 1976-79 was associated with a major recovery in R&D spending. However, because of the earlier decline, outlays for R&D accounted for a considerably lower share of GNP than during the late 1960s. In 1963-68, R&D spending averaged just under 2.9 percent GNP. By comparison, in 1979, R&D spending had fallen to 2.25 percent of GNP. Despite the recovery in R&D spending during the late 1970s, the fact that the share of GNP comprised by R&D outlays actually declined at this time indicates that the upturn in R&D expenditures lagged behind the recovery in the rest of the economy.

Part of the cause of the deterioration of R&D expenditures has had to do with decreases in Federal allocations for research, resulting from the de-escalation of the Vietnam War and the gradual shift in the composition of Federal spending for defense/related activities to transfer payments. However, the major causes had to do with a deterioration in private R&D spending during the early 1970s, which appears to be attributable to depressed profitability. During the recovery of 1971-73, real profits failed to reach their peak levels of the late 1960s, while profitability underwent serious cyclical declines during the recessions of 1969-70 and 1974-75. Private R&D spending followed a similar course. Industry spending for R&D peaked in 1969, and declined in real terms until 1975. Thereafter, there was a recovery in R&D outlays, but because of the earlier decline, R&D allocations did not surpass their level of 1969 until 1977. In other words, the decline in R&D spending was not limited to the Federal government, but was also in evidence in the private sector.

Compared with other major industrial countries, the share of GNP devoted to non-military research in the United States has been unfavorably low. Measured in terms of total R&D allocations, the United States has had the highest ratio of R&D to GNP of every major industrial country except the Soviet Union. However, this is due primarily to the higher level of military expenditures in the United States. When military R&D expenditures are factored out, the ratio of civilian R&D to GNP in the United States has averaged below the corresponding ratios for West Germany and Japan, and has been roughly equal to the ratios for France and the United Kingdom.

In essence, the United States has faced a serious long run problem of deterioration in R&D spending. The causes have had to do partially with a corresponding decline in profitability—during the early 1970s, real corporate profits fell below their peak levels of the late 1970s, and did not improve until the recovery of 1976-

¹ The two major R&D incentives contained in ERTA are (1) a 25 percent tax credit on incremental R&D expenditures, which is scheduled to expire at the end of 1985 and (2) a moratorium for two taxable years on the applicability of Regulations Section 1.861-8 to domestic R&D expenditures. The latter provision is the subject of this hearing.

79. This deterioration in profitability in turn reflects excessive taxation of corporate income. In this respect, the decline in R&D spending is indirectly traceable to the increase in effective corporate tax liabilities during the 1970s. This in itself argues for the retention of tax incentives for R&D, as well as, for that matter, the preservation of ERTA's other business tax provisions.

A further argument is to be found in the fact that, prior to the enactment of ERTA, the tax treatment of R&D expenditures in the United States was for the most part inferior to R&D tax provisions in the other industrial countries. For this reason, achieving higher rates of R&D spending over the next few years will require preservation of special R&D tax incentives, as well as the other ERTA business tax provisions, which will facilitate reliquification and a recovery in profitability.

There is encouraging preliminary evidence regarding the success of ERTA's R&D provisions over the past two years. Notwithstanding the fact that the economic environment has been highly inconducive to higher research spending, both total and private allocations for R&D have increased in real terms. Real corporate profits declined by 22 percent peak-to-through during the recession of 1981-82, and corporate liquidity has deteriorated to its lowest postwar level. Since the level of R&D spending is partially determined by the current profitability and liquidity of the business sector, this situation would ordinarily be associated with a serious decline in R&D spending. However, as the evidence presented in Table 1 indicates, this has not been the case. Instead, R&D spending increased in 1981-82. In constant dollars, total R&D outlays increased 5.2 percent, while industrial R&D increased 10.2 percent.

Just how good this performance is can be evidenced through a comparison of R&D spending during the 1981-82 recession with the recession of 1974-75, when ERTA's R&D tax incentives were not in place and effective corporate tax liabilities were substantially higher. Although the recessions of 1981-82 and 1974-75 were comparable in terms of length and depth, total R&D spending in 1974-75 fell by 3.1 percent, while industrial R&D spending was essentially flat, which compares unfavorably with the increases recorded during the recession of 1981-82.

Finally, as previously alluded to, further evidence of the desirability of retaining provisions in our tax laws favorable to R&D is provided by a comparison of the U.S. with other major industrial countries. Prior to ERTA, the tax treatment of R&D in the United States was inferior to that in other industrial countries, where various special R&D tax treatments were allowed in addition to deductibility of R&D expenses. It was only after the enactment of ERTA that the tax treatment of R&D in the United States became comparable to that of our major competitors.

In Canada, current and capital expenditures for research are fully deductible in the year incurred. There is a 7-percent general investment tax credit for capital expenditures which can also be applied to research-oriented investment spending, and a credit varying between 10 percent and 25 percent for research expenditures. There is also a 50-percent tax credit for incremental research spending in excess of a three year base period amount. Contributions to scientific establishments are also tax deductible.

In West Germany, R&D expenditures are deductible in the year in which they are incurred. Capital expenditures for research facilities are subject to accelerated depreciation, i.e., they are eligible for additional depreciation in the initial write-off period. The acquisitions cost for research conducted by other institutions is depreciable over the useful life of the asset. There is a 7.5-percent investment tax credit for capital expenditures used in research. Individuals engaged in research are subject to preferential tax treatment, including a 50-percent reduction on the valuation of income derived from patents and a 50-percent reduction in qualifying wage income. Qualifying research organizations are exempt from income and net wealth taxes, and contributions to research organizations are tax deductible.

In France, R&D expenditures are deductible in the year in which they are incurred. Capital equipment used for research may be depreciated either through straight-line depreciation (which applies to all other categories of capital assets) or through declining balance methods. Buildings used for research are eligible for faster write-offs. Fifty percent of corporate investments in research organizations are fully deductible. Qualifying income resulting from sales of patents are subject to preferential treatment.

In essence, up to 1981, tax provisions for R&D in other industrial countries were significantly better than in the United States, giving them considerable competitive advantages in international markets. The R&D tax provisions enacted under ERTA have substantially redressed this inequity by granting American corporations access to the same kinds of R&D tax incentives that their foreign competitors enjoy.

RESCISSION OF SECTION 1.861-8

Under Section 1.861-8 of the Treasury Regulations, R&D deductions along with general and administrative expenses must be allocated among domestic and foreign sources of income. In 1981, the applicability of Section 1.861-8 to domestic R&D expenditures was subjected to a two-year moratorium. In addition to the general need for retention of tax provisions favorable to domestic R&D, we note the following specific evidence in support of our recommendation. These specifics are drawn primarily from a recent study by Arthur Andersen & Company, which study was sponsored by NAM and several other business organizations.

First, the result of the R&D allocation requirements of Section 1.861-8 has generally been to increase effective corporate tax liabilities. The main reason has been that as a result of R&D allocations, American-based multinational companies have frequently found themselves in an excess foreign tax credit situation on their domestic income tax returns. This problem was in evidence in 35 percent of companies studied for the period 1977-80, and in each case, the net effect was an increase in tax liability. A larger share of companies studied (44 percent) indicated that an end to the moratorium on Section 1.861-8 R&D expense allocations would cause or contribute to an excess foreign tax credit situation in subsequent years. The implication is that in many cases, Section 1.861-8 either has, or absent any demonstrable past effects can be expected to, reduce domestic R&D outlays by reducing after-tax cash flow, and by creating an additional regulatory disincentive to research.

Both the existence of the regulation and the recent moratorium are cited as factors influencing decisions to undertake R&D spending. The Section 1.861-8 moratorium has contributed to the conducting of a greater share of R&D activity in the United States. Conversely, the regulation itself, and pre-ERTA treatment of R&D generally, have in the past constituted a deterrent to domestic R&D spending. Companies studied cited repeated instances of research activities which were hampered or curtailed because of unfavorable tax treatment of R&D, and Section 1.861-8 was frequently singled out as one of the most objectionable components of the pre-ERTA R&D tax treatment.

Corporations have characterized this regulation as inefficient, arbitrary in its formulations, unnecessarily complex, and inadequately defined. The validity of the regulation has also been called into question on the grounds that it exceeds the statutory mandate of the tax laws as interpreted through the process of judicial review. Major areas in which Section 1.861-8 created administrative difficulties have had to do with allocation of expenses within SIC categories, limitations on the geographic apportionment of expenses, and apportionment on the basis of sales. The data collection requirements of this regulation have typically involved considerable costs, as well as considerable expenditure of time. The validity of the Treasury assumption underlying this regulation—that domestic R&D benefits foreign operations while foreign R&D does not have an equiproportionate effect on domestic operations—has been strongly questioned.

A further effect of Section 1.861-8 has been to shift research activity by American corporations overseas. Of the companies studied, a majority have exhibited an increase in the ratio of R&D expenditures conducted through foreign affiliates to total R&D outlays. This trend was particularly visible among the smaller and intermediate-sized multinationals: companies with less than \$2.5 billion in sales showed the largest increase in the ratio of foreign R&D to total R&D. Side by side with the transfer of research expenditures overseas, there has been a simultaneous reallocation of personnel engaged in research into foreign affiliates. The number of scientists, skilled engineers and other research personnel employed by the foreign affiliates of multinationals has typically increased more rapidly than employment of research personnel in the parent company. The degree to which this effect has been produced by tax regulations rather than by foreign and domestic growth rates can be evidenced by the fact that the rise in the ratio of foreign to total R&D was typically greater than the change in the ratio of foreign to total sales. In other words, the reallocation of research activity overseas was not a result of faster expansion of foreign operations. Rather, it occurred independently of growth in foreign sales.

The net result has been a reallocation of research activity overseas which is not justified on economic grounds. In the absence of Section 1.861-8, a substantially larger share of research activity very likely would have been conducted domestically.

In this respect, it is noteworthy that no other industrial country has tax laws which tend to shift R&D overseas; instead, the tax laws of other countries have by and large been designed to insure that research is conducted domestically. While the impact of Section 1.861-8 represents in essence a form of double taxation of for-

eign source income, the tax laws of eight other industrial countries including Canada, West Germany and Japan have been aimed at avoiding such double taxation. The provisions through which double taxation is eliminated or reduced range from credits for foreign taxes, or lower direct taxes on foreign source income. Two countries, France and Australia, do not levy taxes on foreign source income, and in both countries, domestic R&D deductions are not disallowed because of any putative benefits to overseas operations. While Ireland does not provide special credits to offset double taxation, corporations are permitted to deduct fully foreign tax liabilities from their taxable income.

In sum, the provisions of Section 1.861-8 represent an aberration that is unique to the United States. No other country has any comparable law, and in most other countries, tax laws are designed to prevent the shift of R&D overseas that has been engendered by Section 1.861-8.

CONCLUSION

It is apparent that the R&D tax changes enacted in ERTA have contributed to a significant increase in domestic R&D by reducing pre-existing biases in our tax laws against such spending. In the process, they have given American corporations tax advantages comparable to those enjoyed by corporations in other major industrial countries, and in this respect have placed American firms on a more equal competitive footing in world markets.

For these reasons the NAM urges that this subcommittee report favorably proposals making permanent ERTA's 1980 moratorium on the allocation of R&D expenditures under Treasury regulation 1.861-8 which is scheduled to expire imminently.

TABLE 1.—RESEARCH AND DEVELOPMENT EXPENDITURES

Year	Total R&D spending in constant dollars	Percent of GNP	Industrial R&D spending in constant dollars ¹
1960.....	19.6	2.67	16.6
1961.....	20.6	2.73	17.2
1962.....	21.8	2.73	17.6
1963.....	23.7	2.87	18.4
1964.....	25.9	2.96	18.8
1965.....	26.9	2.89	19.2
1966.....	28.4	2.88	19.9
1967.....	29.2	2.89	20.6
1968.....	29.8	2.82	21.3
1969.....	29.6	2.71	21.3
1970.....	28.5	2.63	20.3
1971.....	27.8	2.48	19.6
1972.....	28.4	2.40	19.5
1973.....	29.1	2.32	19.8
1974.....	28.8	2.29	19.9
1975.....	28.2	2.27	20.0
1976.....	29.5	2.26	20.6
1977.....	30.7	2.24	21.7
1978.....	32.0	2.23	22.8
1979.....	33.7	2.25	24.0
1980.....	35.1	2.33	25.3
1981.....	36.1	2.37	26.6
1982.....	36.9	2.45	27.9

¹ Billions of constant 1972 dollars.

Source: National Science Foundation.

Chairman RANGEL. The Electronic Industries Association, which I understand represents a large number of corporations doing business overseas, Mr. McCloskey, the president, is here.

STATEMENT OF PETER F. McCLOSKEY, PRESIDENT, ELECTRONIC INDUSTRIES ASSOCIATION

Mr. McCLOSKEY. Thank you, Mr. Chairman.

The Electronic Industries Association, too, is in favor of making permanent the moratorium on the 861. The importance is that we see the R&D should be performed in the United States. We see as a matter of public policy it is an extremely important thing, that it radiates far beyond the companies performing that research and development into our universities, into our ability to attract good people into the sciences.

I think every other country in the world sees that same thing. That is why they have incentives. Those incentives in other parts of the world exceed the incentives in the ERTA bill with the 25-percent increase in R&D tax credits over the 3-year rolling average.

The competition that exists between all the countries in the world is to have the R&D done in their countries. This is why companies must have manufacturing research facilities and research and development in other countries.

Recognizing that, we shouldn't enhance the reasons that they do it. But we do that when we say you can't deduct research and development performed in the United States totally.

I don't accept Mr. Kingson's argument. I think it is valid from a purist's point of view, but to say that the major reason why we should not have the 861 made permanent is because we ought to have agitation from those companies to have other countries change their policies, is unrealistic.

These other countries are not going to change their policies. There is not one of them that says we will allocate and not make deductible fully the R&D done in their countries.

They do it for public policy reasons of their own. To put the burden back on the companies and say, you agitate, you convince them—that isn't the real world.

Chairman RANGEL. Thank you, Mr. McCloskey.

[The prepared statement of Mr. McCloskey follows:]

STATEMENT OF PETER F. MCCLOSKEY, PRESIDENT, ELECTRONIC INDUSTRIES ASSOCIATION

ORAL STATEMENT

I am Peter F. McCloskey, President of the Electronic Industries Association (EIA), and am accompanied at this hearing by Richard F. Irwin, ITT Corp., Chairman of the EIA Tax Council. R&D is more important than ever to the U.S. economy and to U.S. industry's competitiveness. The connection between R&D and improved productivity is beyond question. R&D, if performed here, produces beneficial results that radiate through the spectrum of industry, its workforce, and the overall tax base.

A connection between research at institutions of higher learning, the availability of scientific faculty and graduate students, and the creation of R&D centers is apparent: Route 128, Research Triangle, Austin TX, Silicon Valley.

ERTA helped us reverse the decline of R&D as a percentage of GNP. It would be foolhardy to provide tax credits for R&D in the USA, yet limit the tax deductibility of funds expended here.

Other countries recognize the importance of R&D. A recent study by Arthur Andersen & Co., examines their incentives. Only the USA denies full deductibility of R&D expenditures made in its territory.

The Export Administration Act is another disincentive structurally favoring the conduct of R&D in some other nation. The diminishing supply of scientists and engineers in the USA is yet another disincentive, tacitly favoring the location of R&D facilities in countries where these disciplines are available. The USA cannot afford to continue at cross-purposes such as these.

Treasury justifies its attitude on 861 by the premise that expenses should be matched with income. In the case of R&D, this premise is technically unsound. Also,

Treasury's quantification of the impact of 1.861-8 does not reckon ripple effects elsewhere in the tax base.

Congress must weigh the evidence and legislate in the nation's best interest. We are confident that this Subcommittee will report favorably on H.R. 1887.

STATEMENT

Mr. Chairman and members of the subcommittee, my name is Peter F. McCloskey. I am the President of the Electronic Industries Association (EIA). Accompanying me today is Richard F. Irwin, Associate General Tax Counsel of ITT Corporation and chairman of the EIA Tax Council.

With more than 1000 participating companies, EIA is the full-service national trade organization representing the entire spectrum of U.S. companies manufacturing electronic products. These include components, equipment, and systems; they are made for industrial, governmental, and consumer end-uses.

In 1982, the electronic industries of the United States generated \$126 billion worth of factory sales, exported over \$24 billion worth of electronic products and imported \$21 billion. We are one of the few manufacturing sectors of the U.S. economy that produced a trade surplus (\$3.2 billion). These figures are an indication that our industries are advancing and that our products are competitive.

The members of our Association, both large and small, made a disproportionately large contribution to the American economy, both by providing taxable profits and by creating badly needed jobs. The electronic industries employed 1.6 million Americans in 1982.

Our success as an industry is dependent on our ability to stay ahead of our foreign competitors in producing products using state-of-the-art technology. This, in turn, requires a high commitment to research and development. We believe it is in the nation's interest that the research and development we must conduct to stay in business be carried on in the United States. We therefore urge that the Congress make permanent the two-year moratorium on the allocation of research and development expense under the section 861 regulations for foreign tax credit purposes so that a full deduction is allowed for all research and development conducted in the United States. Toward that end, we enthusiastically support H.R. 1887 introduced by Congressman Heftel.

Under the section 861 regulations, the allocation of expense rules act as a disincentive to research and development because of the economic cost it imposes on the performance of domestic R&D. The effect of these rules is to deny U.S. corporations a full deduction against U.S. income for purely domestic R&D expenses. Such expenses, when allocated to foreign sales, are not permitted as a deduction against taxable income by foreign tax authorities either, because no direct benefit accrues to the foreign entity. Nor are they viewed as deductible costs of doing business in the foreign country. The result is a loss of tax benefit for a portion of R&D expenses, and exposure for a portion of income to both U.S. and foreign taxation. This occurs because the allocation of R&D expenses to foreign-source income has the effect of reducing the amount of foreign tax credit allowed currently and of increasing the corporation's overall tax liability.

The "National Research and Development Study," recently conducted by Arthur Andersen & Company, shows that the United States is unique in limiting the availability of deductions for research and development. Many other countries such as Japan, Canada, the U.K., Belgium, West Germany, and France encourage research and development through a variety of tax and fiscal incentives. The combined result of foreign incentives and the U.S. disincentives has been documented by the same study. It indicates that R&D investment in foreign markets by U.S. companies is in fact increasing faster than in U.S. markets. A permanent end to this section 861 disincentive is needed to reverse this trend.

At this point, let me emphasize that 861 is not the only disincentive imposed by our own Government on the performance of R&D in the United States. Another is the Export Administration Act, currently pending renewal. This Act provides controls on exports of products and transfers of technology to destinations abroad—not just to Communist countries, but even to allied nations.

As 861, the Export Administration Act structurally favors the performance of R&D abroad—in this case because technologies developed there can more readily be utilized in commerce.

Foreign governments do not impose controls on technology transfers, and they impose much less stringent controls than we do on product exports. As you saw in the press, a highly controversial subject at the Summit Conference with our allies, held at Williamsburg, Virginia, was "East-West Trade." There, the United States

pressed our industrialized allies to impose a system of controls as rigid as ours. As in the past, they simply declined.

A report on the "Williamsburg Declaration" had this to say:

"The question of trade with the Soviet bloc, which was so divisive during and after the Versailles summit, was disposed of in a single paragraph saying East-West economic relations 'should be compatible with our security interests.'"

Rigid controls would curtail business just at a time when unemployment is rampant, our allies explain, and foreign earnings are sorely needed by their exchequers.

My point is this: 861 structurally favors the performance of R&D in foreign countries. R&D expenditures made there can be deducted there. The Export Administration Act structurally favors the performance of R&D in foreign countries. New technologies developed there can be applied to products manufactured there, sold in their domestic markets and exported.

Incidentally, the Washington Post of May 25 carried an article entitled, "U.S. Science Losing Its Magic as Rivals Excel." It maintains that cutbacks in funding basic research here might be inducing American scientists to migrate. If so, this is yet another factor influencing decisions on where to locate R&D facilities.

The disincentives to locating them here must be dismantled. Enacting H.R. 1887 would dismantle one of the least justifiable.

The Treasury Department has, in the past, justified the 861 regulations on the basis that they properly match expenses with income. We submit it is difficult to justify the regulations on this basis when their long-term effect is to raise the cost of conducting R&D in the United States, a cost that management must factor into its long-run decision-making process.

Further, the justification stated above is technically unsound. Since R&D can only generate a future income stream, the regulations would have to allocate current expenses against the present value of future foreign-source income in order to achieve an appropriate matching. The section 1.861-8 allocation is, then, a misallocation which ill-serves both the U.S. Treasury and American research and development objectives.

One would suppose that a tax provision which has so great a potential for harm would at least raise significant revenues. However, this is not the case. A 1982 study written by Dr. Anita Benvignati for the Department of Commerce indicates that the regulations generated only minimal revenues. We expect that this pattern would continue to hold true.

There is no anomaly in our assertion that a provision which provides minimal revenues for the Treasury can cause substantial harm to the U.S. economy. The combination of the section 861 disincentives and foreign incentives must necessarily have an impact on sourcing decisions for research and development. Once an R&D facility is located abroad, the jobs that facility will generate are more or less permanently lost to the U.S. economy. The United States needs to protect and extend its research and development here now. The suspension must be made permanent, and not merely extended for another short period to avoid the harm caused by the Section 861 disincentives. It would be unfortunate if this opportunity to make the suspension permanent were lost.

Mr. Chairman and members of the subcommittee, that concludes my testimony. Mr. Irwin and I stand ready to answer any questions you might have.

Chairman RANGEL. The Emergency Committee for American Trade. Could you describe what that committee is, Mr. McNeill?

STATEMENT OF ROBERT L. McNEILL, EXECUTIVE VICE CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. McNEILL. Yes, the Emergency Committee for American Trade has been in existence for about 15 years. Its initial purpose was to express business opposition to legislation that would have established a grid of import quotas around the United States following conclusion of the Kennedy round in the 1960's.

Our interests are limited to the area of international economic affairs, particularly to the taxation of foreign source income. The 63 members that constitute our organization are heads of corporations who have annual sales of approximately \$700 billion with 5 million employees.

So, they are large companies. They operate worldwide and their economic well-being depends very much on their ability to participate equitably in the international economic arena.

I would imagine the 24 companies that have been identified by Treasury as principle beneficiaries, apparently, of the 861 moratorium, are among my members. They are large, as I have indicated. They employ a lot of people.

In terms of tax policy, I am not competent to talk as to whether the allocation is a good or bad thing. I can repeat to you comments that I have heard from a number of my companies that the double-taxation resultant from the 861 allocations to research and development is such in many instances that at least in terms of incremental research and development expenditures, they are forced economically to look abroad.

I don't see any wholesale movement abroad of our domestic research and development base resting on the resolution of this particular issue, but I do see it as vitally important on an incremental basis so that over a number of years if we maintain our domestic base, but increase substantially our overseas R&D facilities, that that is going to have a deleterious impact.

To be ridiculous and take a hypothetical, if 10 Nobel potential laureats were placed by American companies in laboratories abroad rather than here and inventions took place abroad with enormous economic consequences, that could be very bad in the macroeconomic sense for our economy and for our country.

So we, like the rest of my business colleagues here, would very much like to see not a further 2-year moratorium, but a simple permanent suspension of the R&D requirement on allocation.

Thank you, sir.

[The prepared statement of Mr. McNeill follows:]

STATEMENT OF ROBERT L. MCNEILL, EXECUTIVE VICE CHAIRMAN, EMERGENCY
COMMITTEE FOR AMERICAN TRADE

SUMMARY

- (1) The members of ECAT strongly support passage of H.R. 1887.
- (2) The rebuilding of U.S. leadership in innovation and technology is a critical national priority.
- (3) Internal Revenue Section 1.861-8 is a disincentive to the conduct of research and development in the United States and is thus not in the national interest.
- (4) A study of the impact of Section 1.861-8 on domestic R&D by Arthur Andersen & Co. shows that:
 - (a) The allocation to foreign source income of domestic R&D expenditures increases domestic tax costs.
 - (b) The allocation requirement serves as a disincentive to conducting R&D in the United States.
 - (c) The United States is the only nation requiring the allocation of domestic R&D expenditures.
 - (d) Continuation of the R&D allocation requirement will encourage an expansion of R&D operations abroad.

STATEMENT

Thank you, Mr. Chairman, for allowing me to present the views of the Emergency Committee for American Trade on H.R. 1887, a bill that would amend the tax code to treat deductions for research and development expenses attributable to activities conducted in the United States as allocable to income from sources within the United States.

ECAT is an organization of the heads of 63 large United States corporations with substantial overseas business interests. In 1971, their worldwide sales totalled about \$700 billion. In the same year, their worldwide employment was just over five million. ECAT members are heavily engaged in research and development and have an abiding interest in the provisions of Internal Revenue Code Section 861.

ECAT strongly supports the provisions of H.R. 1887 that would permit U.S. research expenditures to be charged solely against U.S. income for U.S. tax purposes. In 1981, the Congress correctly perceived the inconsistency of the adverse tax consequences for increased U.S. research resulting from the R&D allocation requirements of Section 861 with our stated national goal of increasing U.S. technological innovation. Since foreign governments do not recognize this allocation, the 861 practice increases a company's potential overall tax liability and creates a tax disadvantage to conducting research and development in the United States.

In the Economic Recovery Act of 1981, the Congress imposed a two-year moratorium on the application of the regulations under Section 861 as they applied to research expenses. Unless Congress takes action before the end of this session, the moratorium will expire. Today, it is as apparent as ever that the rebuilding of U.S. leadership in innovation and technology is a critical priority. Therefore, we urge prompt passage of H.R. 1887 to make the moratorium permanent and avoid the uncertainty and disincentives that will otherwise arise if the R&D allocation requirements are reimposed.

Following the 1981 legislation, ECAT was one of several organizations that commissioned a study on national research and development by Arthur Andersen & Co. to analyze the impact of the regulations under Section 861, specifically Section 1.861-8, on corporate taxes and research activity. This study was completed in January 1983, and the principal conclusions confirmed the experience of many of our members:

(a) The research allocation requirements of the regulations (Section 1.861-8) increase the overall tax liability of U.S. multinational corporations by generally placing firms in an excess foreign tax credit position.

(b) Respondents to the survey considered pre-ERTA tax rules as a disincentive to conducting research in the U.S. and regulation Section 1.861-8 was singled out as a detriment to domestic research operations by a significant group.

(c) The United States is the only nation requiring the allocation of domestic research expenditures.

(d) Most respondents believe that lifting the moratorium will encourage an expansion of foreign research investments in the future. In fact, 44 percent of the respondents stated that if the suspension was lifted, it would contribute to an excess foreign tax credit position in future years.

While the issue before the Subcommittee is a little-known, highly technical provision of the Treasury's tax regulations, its impact is, nevertheless, significant. Recently, the distinguished Business-Higher Education Forum, in a report to the President entitled "America's Competitive Challenge: The Need for a National Response," included the following item on its agenda for discussion of increased U.S. competitiveness: "Eliminate Treasury Regulation 1.861-8, which may reduce the incentive to U.S. multinational companies to conduct R&D in the U.S."

ECAT agrees that Section 1.861-8 is a disincentive—a disincentive to U.S. research efforts. This disincentive arises not from a considered choice made between difficult alternatives, but from a mechanical application of separate provisions of the Internal Revenue Code, whose interaction was never considered by the Congress.

In this regard, it is necessary to consider prior actions by Congress with respect to research expenses, research incentives and U.S. taxes.

1. Worldwide taxation and relief from double taxation

The income tax rules adopted by the Congress in 1918 contained the basic principles for taxing the worldwide income of U.S. companies and for relieving them of double taxation by providing a tax credit for foreign taxes imposed upon their foreign income. In 1921, the Internal Revenue Code was further amended to deal with foreign taxpayers having operations in the U.S. This amendment, which is the predecessor of the current Section 861, required the allocation of expenses between domestic and foreign income. General guidelines covering business expenses were promulgated both for domestic and foreign companies. There was no discussion or specific mention of expenses for research in the legislation or the regulations. Indeed, at that time research expenses were generally costs that were capitalized for tax purposes.

2. Deduction for research

In 1954, in a specific action by the Congress to stimulate increased U.S. research, Section 174 of the Internal Revenue Code of 1954 authorized the immediate expensing of research costs. No consideration was given to the question of the allocation of such expenses between domestic and foreign income.

3. Treasury revision of expense allocations

It was not until the early 1970s that the Treasury initiated a massive revision of the regulations for allocations under the 50-year-old Section 861. The end result transformed what had historically been a few sentences in the regulations into dozens of pages of text, formulae, and examples. The proposed regulations in 1973 added for the first time a rule specifically allocating research expenditures, and did so on a highly theoretical basis. After several years of intense controversy, the Treasury issued revised regulations under Section 861, generally effective on January 1, 1977. These regulations adopted 56 years after the statute they interpreted had been enacted and 23 years after Congress authorized the current deduction for research, included the section specifically allocating research expense abroad.

4. Incentive credit for research

In 1981, as the adverse effects of the regulations were just being fully felt, Congress sought to stimulate U.S. research through the enactment of the 25 percent incremental R&D tax credit. With the support of the Administration, Congress also imposed the current moratorium on the research portion of the 861 regulations.

5. How are the regulations a disincentive?

The disincentive effect of the regulations is created by reducing the available credit for foreign taxes paid by a U.S. taxpayer on foreign source income. The regulations require that the deduction for domestic research allowed as an incentive by Section 174 of the Code be allocated between the current U.S. and foreign income of the U.S. taxpayer. For U.S. tax purposes, the allocation of the expense against foreign source income reduces the amount of the foreign income—but it obviously cannot reduce the amount of the foreign tax actually paid. Although U.S. tax law provides a tax credit for foreign taxes paid on income earned abroad, foreign countries ordinarily and understandably do not permit a deduction for research performed in the United States. The result is that part or all of the foreign tax cannot be claimed as a credit, even though it has been paid in full to the foreign government. The stimulative effect of the immediate U.S. deduction for the research expense is thus offset by the loss of foreign tax credits. A 1980 Treasury study summarized this adverse effect as equivalent to losing the benefit of a portion of the deduction otherwise allowed:

"By denying U.S. corporations a full deduction for domestic R&D expenses against domestic income and by assigning some portion to foreign source income, where it often is not allowed as a deduction for part of R&D expenses, the apportionment can effectively deny any tax deduction for a part of R&D expenses."—A. M. Benvignati, "The Tax Treatment of Research and Development (R&D) Expenditures of Multinational Corporations: The Impact of Regulation 1.861-8." U.S. Treasury Department Office of Tax Analysis, December 1980.

Even if the Treasury were to tinker with the regulations to try to draw industry-by-industry distinctions or distinctions between new companies and old companies or large or small companies or similar tailoring of theoretical rules, the fact would remain the same. As companies increase their research in the United States, they encounter the disincentive effects of the R&D allocation requirements. The United States allocated these U.S. expenses to foreign income; foreign governments do not recognize these expenses and the foreign taxes exceed the U.S. tax on the same income. This result is intensified as U.S. research is increased.

Whatever tax policy argument can be marshalled for the theory that the research undertaken by U.S. companies should be allocated to income from abroad should be weighed against the answer to these questions:

A. If the regulation is reinstated, what will be the effect on incremental U.S. research?

An increase in U.S. research raises the worldwide effective tax rate for a U.S. company that is presently paying foreign taxes of its foreign income equal to the U.S. tax on such income. Thus, even if U.S. and foreign tax rates are identical and remain static, a U.S. firm increasing its U.S. research would incur a greater tax penalty in the form of increased loss of foreign tax credits.

B. Aren't the deductions and allocations related to the foreign income?

The relationship is only in the most theoretical and arbitrary sense. The deductions are for current research that has not produced the foreign income against which the expense is allocated. Indeed, there is no effort to trace prior U.S. research to those products into which it may or may not have been incorporated. For example, if a U.S. company manufactures trucks in the United States for sale in North America and might someday send a design for any part of a motor vehicle abroad (perhaps for lawn mowers made by an affiliate in Germany), then all 1983 dividends repatriated from that German affiliate will have a portion of the total 1983 truck research expense of the U.S. company allocated to the dividend. No consideration is given to the earnings out of which that dividend was paid, whether or not it arose from lawn mowers and even if the lawn mower production in Germany had lost money. German tax authorities will have given no deduction for a theoretical benefit to Germany, and the German income taxes will be on a higher base than the U.S. tax base. Tracing expenses to particular sales is not attempted under the regulations because it would be extremely difficult.

C. Do other countries have rules similar to those contained in the suspended Treasury regulations?

No other developed country has adopted a similar allocation rule. There is no similar rule, for example, in Japan, Germany, France, Canada or the U.K. Most of those countries have concentrated upon the adoption of special tax rules to encourage domestic research.

D. Shouldn't the foreign country provide a deduction for U.S. research expense?

That is certainly arguable if an allocation system is to work. But since that would have the effect of encouraging continued and expanded U.S. research, one shouldn't hold one's breath waiting for such a rule to be adopted by foreign countries.

E. How can the effect of the Treasury regulations be avoided?

There are many reasons why a U.S. company would prefer to conduct its research in the United States, and why it will accept some additional costs to do so. Nevertheless, the incontrovertible fact is that under the scheme of the 861.8 regulation, one way a U.S. firm can reduce the resulting tax credit penalty is to conduct additional research abroad. Indeed, for a business which has one-half of its sales in the U.S. and one-half abroad and pays the same rate of tax in the U.S. and abroad, an optimum tax result would be realized by conducting at least one-half of its research abroad. The practical effect is contrary to U.S. interests and is exactly the opposite of that intended by Congress in adopting the research credit incentive in 1981.

The mix of foreign and domestic source income varies among U.S. companies and, therefore, the impact of the regulations does not affect all companies today. The trend line, however, is toward higher worldwide earnings, and it is hoped, increased U.S. research; this means that an increasing number of U.S. companies will be affected by the disincentive to domestic research intrinsic in regulations Section 1.861-8.

Chairman RANGEL. I want to thank you, especially you, Mr. McNeill, for your candor in terms of whether or not we would see a big rush overseas. Of course, we all speculate. We don't know.

It would appear to me that on a matter such as this, that each one of you would be more or less forced to support any legislation that would maximize profits, or to put it another way, that would decrease tax liability and so I accept that.

That is your position and it should be that because that is what you are paid to do.

Now that we are concerned about maximizing competition with U.S. industries and maximizing jobs and research and development activities, I would assume if we could be more liberal with our R&D tax credits for all companies—multinational, national, small companies—that you would not object to reducing your tax liability

by providing a larger R&D tax credit to encourage people to have their scientists do work here.

Nobody would object to that. Right?

Mr. McCLOSKEY. If you could make that credit exceed the value of the deduction.

Chairman RANGEL. That is what I am talking about. You are forced to maintain the argument on the moratorium. This doesn't necessarily mean that the five of you couldn't get together and come up with some policy incentive that would not exclude those corporations that are not multinational. Isn't that so?

Mr. McNEILL. Mr. Chairman, I can't speak for my colleagues, but I think the answer to that would be affirmative. Our concern here is with the fact that we do represent companies with overseas business, so I don't think that one is exclusive of the other.

I think we would applaud the objective that you suggest but at the same time we would not want to continue or be penalized by having to—

Chairman RANGEL. What you are saying is, I guess, which makes sense, of course, is that you know what you got under the moratorium, so you are not prepared to discuss anything else until there was some definite type of tax proposal before you and then you would weigh the terms of what your tax liability would be and then you could answer.

Mr. McCLOSKEY. But a simple extension of the 25-percent tax credit would not nearly do that.

Chairman RANGEL. I didn't say that. I didn't say that. I am just saying that it would appear to me that with your expertise in this area and ability to understand tax policy, that you could come up with some type of a tax policy that would not just deal with the multinationals but would also provide an incentive for all the United States-based industries to be encouraged to expand R&D and be competitive. I know that none of you feel particularly comfortable in asking us to legislate where 80 percent of the benefit will go to 20 companies.

Mr. SCHICK. Mr. Chairman, we have spoken about these 24 companies and I don't know who they are and I have no basis to say that that number is right or wrong. But my impression had been that it was a much larger group.

I thought Mr. Hufbauer's testimony was interesting in that Mr. Hufbauer said that he participated in the preparation of the regulations. I didn't know some of the history that he told. I didn't know it existed until he came here.

He said in his paper that one of the reasons that the regulations were written as they were—which I call arbitrary, but I don't think he used that word—was that the IRS was faced with terrible disputes in the field because there was no agreement on how to make proper allocations of the R&D and that one of the reasons that they promulgated these regulations and spent so much time was because of the multiplicity of the lawsuits.

Now, you know, maybe they were only concerned about 24 lawsuits, but that doesn't seem credible to me, that at the time it was conceived of as a broad question.

I think that the 861 problem is really standing on its own. It is not right to look at it only as an economic policy. One of the rea-

sons that we are here today is that the allocations are wrong and I don't think that—companies don't like to not get deductions for items that are properly allocable to U.S. source income.

If you try to attack the problem in another way, you will still leave that increased tax cost by doing it in the United States rather than abroad and that is wrong.

So that is why we come to the conclusion that this is broader than 24 companies. It has a long-term effect. The regulations probably cannot be corrected.

If they could be corrected, some of the problems would go away. But the simplest way to do it is to simply require that the U.S. R&D be allocated to U.S. source income.

Chairman RANGEL. You say it is wrong because other countries have a different formula?

Mr. SCHICK. No; it is wrong because the system in the regulations allocates U.S. R&D to products to income earned abroad that has absolutely nothing to do with the R&D.

Chairman RANGEL. Are you saying the expense of R&D done in the United States has nothing to do with manufacturing efforts being done abroad?

Mr. SCHICK. There is an example in the regulations which to me is preposterous, although I am not an expert—

Chairman RANGEL. Let me accept the fact that there are examples that are preposterous. I don't argue that.

My Oversight Subcommittee has a responsibility to look into those and try to correct them. I am just saying that what you are saying is that allocation of expenses incurred in the United States just doesn't make sense at all.

Mr. SCHICK. I can understand from a purist's policy viewpoint that you have to, under our system, make a proper computation of foreign source income. I have absolutely no quarrel with that.

Now, once having made that, it could end up to be a disincentive of the type we are talking about. Then what we are talking about is an economic issue and—

Chairman RANGEL. That is all I am talking about.

Mr. SCHICK. Excuse me.

Chairman RANGEL. All I am saying is, is there a better way to deal with economic issues? That is all.

Mr. McCLOSKEY. Could I comment on the 24 companies?

As I understand, the issue was that some 80 percent or so of the benefit is accruing to 24 companies.

Chairman RANGEL. That is right.

Mr. McCLOSKEY. But that is not surprising. The Business Week edition of the research and development performed in 1982 showed that the top 15 companies performing research and development did 42 percent of the R&D.

I don't know what the figure is for the top 24 companies, but I doubt that it is disproportionate.

Chairman RANGEL. It doesn't surprise me. And we are talking about corporations with foreign excess credits so you start finding out who has the excess credits and we find out who will be affected.

I don't mind special interest legislation if it serves the national purpose. It doesn't bother me.

I just hate going through the motions of changing regulations, suspending them, and passing legislation when it is special legislation.

I think we should find out who we want to help and help them. Then let the voters decide that the economy would recover as a result and it makes us competitive.

It is just that the legislation appears to be general but the beneficiaries are not.

Mr. Martin?

Mr. MARTIN. Thank you, Mr. Chairman.

What you are saying essentially is that under the moratorium, if domestic research is counted only in relation to the U.S. tax, that that has the effect of biasing your R&D investment decisions in favor of investing in research in the United States rather than overseas?

There are a variety of factors, some of which would favor an overseas' affiliate, and some favor a parent company of one of your research labs in the United States. But you are saying the effect of the R&D incentive in the tax law is a powerful bias in favor of the research being done here in the United States?

Mr. McCLOSKEY. Yes.

Mr. MARTIN. Therefore, because of that you are saying that if we repeal that moratorium and go back to the application of the regulation, then U.S. research which is not an overseas cost, would be counted as though it were and that will remove that favorable bias, favorable insofar as doing R&D in the United States and, therefore, will lead to expansion because of other reasons of shifting more and more of your research investment overseas. Is that essentially it?

Mr. McCLOSKEY. Yes, sir.

Mr. MARTIN. In other words, I am getting it right?

Mr. McCLOSKEY. Yes.

Mr. McNEILL. Mr. Martin, one of the problems we face is that—take a company with \$100 of income, for example, 50 percent of its business is domestic and the other half of its business is in France. If it has a \$100 research and development budget, the allocation requirement would be that \$50 of that expense would be apportioned to your overseas income.

The problem there is that when you—

Mr. MARTIN. You wouldn't get to deduct it overseas.

Mr. McNEILL. When you go to the French Ministry of Finance and say, "Here, here is \$50 worth of R&D done in Peoria, Ill. We want a deduction for \$50."

We don't get it. Therefore it has the effect of increasing very substantially your cost of doing business, and as it becomes more expensive to do R&D in this country relative to elsewhere, companies are forced to look to where they are going to locate their research and development activity.

Mr. MARTIN. Those kinds of relative costs here and overseas will relate to the quality of work here and overseas and sometimes they will be favorable here and presumably sometimes they are favorable overseas.

Mr. McNEILL. That is right.

Mr. MARTIN. I was just saying that not only are you concerned about removing the favorable bias in favor of doing research in the United States, you are also concerned that if the moratorium is not continued or if the suspension is not continued it also replaces that domestically favorable bias with an overseas favorable bias because the only way to deduct that research expense from any tax liability is to do it overseas.

Mr. McNEILL. Yes, sir. That is correct.

Mr. McCLOSKEY. Yes, sir.

Mr. McNEILL. I know of a company in my membership that has research and development facilities, laboratories, that are old and require replacement, and the question facing that particular company is where do we relocate those laboratories, whether to build new ones here or, for example, in Canada which has favorable tax considerations respecting research and development.

So this issue we are discussing here, the apportionment issue which raises the tax cost of doing research and development here, becomes a factor in that corporation's decision as to what to do.

So long as you have a suspension such as a 2-year moratorium, and the administration suggesting a further 2 years, the tax planning becomes very difficult because of that uncertainty. What we are saying here as representatives of business is that we would prefer a simple, absolute permanent suspension for purposes of knowing what the future is and how we can operate.

Mr. MARTIN. Thank you, Mr. Chairman.

Mr. ANTHONY [presiding]. Mr. Franasiak.

Mr. FRANASIAK. Frequently in dealing with tax policy issues we have to rely on data. I must add that the data used to come up with the 24 is dated data. We live in an economy where high-technology companies are growing by leaps and bounds. Whoever heard of an Apple computer 10 years ago? Whoever heard of a National Semiconductor 10 years ago?

I think the point of the 24 companies can be overplayed. We are talking about a very youthful and vibrant sector of our economy and if we simply go with a simple number of 24 we are going to be wrong and we will be wrong in ways we cannot even now today predict.

We are going to sap the lifeblood of our technology and we are going to sacrifice it all in the name of some statistic that was several years old.

I think that is an important consideration that needs to be made when this committee deliberates on what they will recommend to the full committee.

Mr. ANTHONY. Thank you.

Anybody else on the panel have a closing comment they would like to make? If not, the Oversight Subcommittee thanks you for your participation in this matter.

Now we have Mr. Hardiek, director of taxes for Deere & Co.; and Paul Cherecwich, Jr., tax manager for the Foxboro Co.

Mr. Hardiek, why don't you proceed. Your full testimony will be made a part of the record and you may summarize or read it.

**STATEMENT OF BERNARD L. HARDIEK, DIRECTOR OF TAXES,
DEERE & CO., MOLINE, ILL.**

Mr. HARDIEK. This is about the time we get the lunch box out in Moline, so I will summarize quite a bit of it.

I wanted you to know that Deere & Co., or "John Deere" as we are perhaps better known, manufactures, distributes, and finances a broad line of farm and construction equipment. We are the largest manufacturer of farm equipment in the world, employing some 48,000 people worldwide. Last year, the 3,500 independent dealers marketing Deere equipment registered total sales in excess of \$4.6 billion.

When most people think of research and development, the name John Deere may not immediately come to mind. However, in recent years we have ranked consistently within the top 25 companies in the United States in terms of total R&D expenditures. In 1982, Deere & Co. employed over 3,500 people engaged in research and spent \$242 million on research and development. Stated another way, Deere spent almost \$1 million each working day on R&D. Over 90 percent of the cost of our R&D was incurred in the United States. We also think it is significant that our company's investment in research and development has averaged over 4 cents of each sales dollar in recent years.

You have already received testimony on 861 and what it does to the foreign tax credit. Really it is Deere's concern that in the past year and prior years the excess foreign tax credits have in effect resulted in a loss of deductions in the United States for certain R&D expenses which were allocated against our foreign source income.

I would like to give you the benefit of a study that I did approximately 2 years ago which I have since updated. Deere sells anywhere between \$400 and \$500 million worth of farm and industrial equipment in Canada. The question arose as to whether or not Deere should have a research facility in Canada. If you will turn to the last page of my testimony on exhibit A, I would like to go through the comparison that we did to show Deere & Co. senior management what would happen if we put an R&D facility in Canada.

We assumed that the cost of the research facility would be \$20 million and that for each year thereafter that facility would spend roughly \$10 million a year on R&D and that there would be somewhere between 100 and 150 positions involved. The depreciation on the facility in the United States in the first year would have been \$2.4 billion. In Canada you would be entitled to deduct the entire cost of the facility in the first year.

In both the United States and Canada the \$10 million of R&D incurred in that year would be fully deductible.

In Canada you also would have been entitled to an additional deduction of 50 percent of the excess of current expenditures over the 3-year prior average. That results in an additional \$15 million deduction in Canada for R&D.

Then we would have had to deduct the R&D credit from our expenses and then I have tax affecting this at the 46-percent rate.

The benefit in the United States would have been \$5.7 million, in Canada, \$19.3 million.

The R&D credit in the United States would have been \$2.5 million, in other words, 25 percent of that \$10 million current R&D; but in Canada not only the current R&D but also the building would have qualified for a credit, so we would have received a \$3 million credit.

Then in the United States we would have had an adverse effect from 861, of \$644,000, so our taxes in Canada would have been reduced by \$22.3 million whereas in the United States they would have been reduced by \$7.5 million.

So in the first year Deere would have been better off by \$14,760,000 in taxes by putting that R&D facility in Canada instead of the United States.

Now some of that is a permanent difference and some of that is a timing difference. I have tried in the schedule below to indicate the difference between those. Eight million ninety-six thousand of that benefit would have been timing. In other words, we deducted the building in the first year instead of spreading it over 15 years.

But the additional deduction of \$6.9 million was permanent and the \$644,000 of the R&D allocated to foreign source income was also a permanent difference.

I think that what you can see from this is that Canada as well as other countries have afforded a high degree of desirability to keep R&D being performed in their own country instead of letting it go to foreign countries. The significant benefits available in Canada compared to the United States become even more important when you consider Canada's geographical proximity, business environment, cultural similarities, and economic stability.

But Canada is certainly not alone in encouraging R&D through tax incentives. Germany, France, Japan, Belgium, Denmark, Mexico, Norway, Spain, and Sweden also offer significant tax incentives for R&D.

Deere & Co. encourages this committee to act favorably on this bill and to make permanent the provision that would no longer require any allocation of R&D performed in the United States against foreign source income.

We have one further additional comment of a technical nature regarding H.R.1887. We believe the subcommittee should add language which would clarify the fact that the bill would only apply to the calculation of foreign tax credits and would not affect the DISC in any way. In other words, we don't believe it to be the intent of the bill to take the disincentive on R&D from the foreign tax credit and move it over to the DISC.

[The prepared statement of Mr. Hardiek follows:]

STATEMENT OF BERNARD L. HARDIEK, DIRECTOR OF TAXES, DEERE & CO.

I am Bernard L. Hardiek, Director of Taxes, Deere & Company, Moline, Illinois. Deere—or John Deere, as we are perhaps better known—manufactures, distributes and finances a broad line of farm and construction equipment. We are the largest manufacturer of farm equipment in the world, employing some 48,000 people worldwide. Last year, the 3,500 independent dealers marketing Deere equipment registered total sales in excess of \$4.6 billion.

We commend the Ways & Means Committee for the interest shown in the important area of taxation of research and development expenditures. Deere & Company

supports H.R. 1887 because the time has come for R&D to be encouraged rather than discouraged by the tax laws of this county. Research and development will lead to increased productivity and will help to achieve non-inflationary increase in personal income.

When most people think of research and development, the name John Deere may not immediately come to mind. However, in recent years we have ranked consistently within the top 25 companies in the United States in terms of total R&D expenditures. In 1982, Deere & Company employed over 3,500 people engaged in research and spent \$242 million on research and development. Stated another way, Deere spent almost \$1 million each working day on R&D. Over 90 percent of the cost of our R&D was incurred in the United States. We also think it is significant that our Company's investment in research and development has averaged over four cents of each sales dollar in recent years.

Our research covers a broad range of projects. Metallurgists at our research facilities are involved in low-gravity metal research projects, sharing technology with the National Aeronautics & Space Administration for use on upcoming space shuttle flights. Our goal is to develop a stronger iron. In addition, exhaustive and, I might add, expensive, research contributed to the construction of our newly-opened two million square foot, award winning Waterloo Tractor Works. This factory has been recognized as the industry leader in state-of-the art computer based technology. Effective use of research has allowed us to remain a competitive manufacturer of advanced farm and construction equipment with productive innovations which U.S. farmers, contractors and small business owners find necessary to meet their business challenges.

Most will agree that research and development primarily benefits the country in which it is performed. For this reason, other countries offer substantial tax incentives for R&D performed within their borders. However, until 1981, U.S. tax law acted as a disincentive to the performance of R&D in the United States. This disincentive was the ultimate effect of Section 861(b) of the Internal Revenue Code and Section 1.861-8(e)(3) of the Regulations. This combination of Statute and Regulation required that the cost of R&D performed in the United States arbitrarily be divided between foreign and domestic income even though the R&D was performed entirely in the United States. The R&D allocated against foreign income has the affect of reducing the limitation for foreign tax credits, which then reduces the foreign tax credit allowable if foreign taxes paid exceed the limitation. This increases the total U.S. tax payable. Let me give you an example to demonstrate this point:

Foreign tax credit calculation

(Dollars in millions)

Foreign tax credit before R&D allocation:	
Foreign source income before R&D allocation.....	\$10.0
Foreign tax credit limitation (46 percent of 10.0).....	\$4.6
Foreign taxes paid.....	\$4.8
Foreign tax credit allowable	\$4.6
R&D allocation under section 861:	
Total R&D performed in the United States	\$6.0
Foreign sales as a percent of total sales	20
R&D allocated to foreign source income.....	\$1.20
Foreign tax credit after R&D allocation:	
Foreign source income before R&D allocation.....	\$10.0
Less R&D allocated to foreign source income.....	(\$1.2)
Net foreign source income	\$8.8
Foreign tax credit limitation (46 percent of 8.8).....	\$4.0
Foreign taxes paid.....	\$4.8
Foreign tax credit allowable	\$4.0
Reduced foreign tax credit caused by section 861 allocation of R&D:	
Foreign tax credit allowable before R&D allocation	\$4.6
Foreign tax credit allowable after R&D allocation.....	\$4.0
Reduced foreign tax credit.....	\$.6

The allocation of R&D against foreign source income results in a reduction of the allowable foreign tax credit by \$600,000. This taxpayer's penalty for performing \$6 million of R&D in the U.S. is therefore \$600,000 in additional U.S. income taxes. If that R&D had been performed in any other country, it would have resulted in no

such increase in foreign or U.S. taxes. This is so because no other country besides the United States requires such an allocation or apportionment of R&D expenses. When a taxpayer has excess foreign tax credits, the effect of apportioning R&D performed in the U.S. to foreign source income is the same as disallowing a deduction for the R&D performed in the United States. This provides a disincentive to performing R&D in the U.S., encourages the movement of R&D out of this country, and gives foreign companies a competitive advantage over U.S. companies who perform R&D here in this country. The U.S. Treasury gains only a minimal benefit—a benefit which we believe would be easily overshadowed by the increased taxes due to the Treasury as a result of the taxable income generated by the increased productivity.

John Deere, and most other companies who make substantial expenditures for R&D, often must decide where an R&D facility should be established when a need arises for a new facility. Many factors are considered in the study, including the cost of various taxes. Exhibit A, attached, shows the tax cost of locating an R&D facility in the United States, compared to Canada. The analysis assumes an initial cost of the facility of \$20 million and an annual expenditure of \$10 million for R&D. This shows that Canadian taxes would be \$14,760,000 less than U.S. taxes in the first year! The dramatic difference in tax is caused by the fact that Canada has recognized the significance of having R&D performed in that country and has provided the following tax incentives:

(1) A deduction for the entire cost of the facility is allowed in the first year. In the U.S., it must be depreciated over 15 years.

(2) An additional deduction is allowed for 50 percent of the excess of current R&D expenditures, including capital assets, over the prior 3-year average. In the U.S., no additional deduction is allowable.

(3) The R&D credit in Canada is allowed on all R&D expenditures, including capital assets, while the R&D credit in the U.S. is allowed only on direct R&D costs, excluding capital assets, and applies to only the increase in R&D.

The significant benefits available to taxpayers performing R&D in Canada, compared to the U.S., become even more important when one considers Canada's geographical proximity, business environment, language and cultural similarities and economic stability. However, Canada is not alone in encouraging R&D through tax incentives.

Germany allows a 20 percent tax credit on the first DM 500,000 and 7.5 percent on the balance of any amounts spent for assets used for R&D purposes.

France provides an additional deduction equal to 10 percent of the cost of assets used for R&D purposes. R&D buildings are eligible for a 50 percent special depreciation allowance. In addition, France will pay cash grants for certain R&D expenditures.

Japan has allowed an R&D credit since 1966. The credit is equal to 20 percent of the excess of current expenditures over the largest amount of R&D expenditures in any tax year since 1966. Japan also allows a deduction of 16 to 28 percent for companies that receive income from overseas transactions in technical services.

Belgium, Denmark, Mexico, Norway, Spain and Sweden also offer various tax incentives to encourage R&D.

The Economic Recovery Tax Act of 1981 took an important step forward by temporarily removing the disincentive to perform R&D in the United States. As you know, it suspended for two years the provisions of Section 861 which required the allocation of R&D expenses against foreign source income. However, this suspension expires at the end of 1983. H.R. 1887 would permanently remove the disincentive by providing that no R&D performed in the United States would be allocated against foreign source income. Deere & Company urges this subcommittee to act favorably on this bill.

We do have one additional comment of a technical nature regarding H.R. 1887. We believe the Subcommittee should add language clarifying the fact that the bill would only apply to the calculation of the foreign tax credit and would not affect the DISC in any way.

In summary, John Deere believes that it is in the best interest of this country to remove the disincentive to perform R&D in the U.S. which is caused by Section 861 by enacting the provisions of H.R. 1887. The increased R&D and greater productivity which should result, will help establish the framework needed for substantial economic growth.

I sincerely appreciate the opportunity to provide to you John Deere's views.

EXHIBIT A

Comparison of United States and Canadian R&D tax laws

Assume a new \$20 million research facility which spends \$10 million for R&D each year. Compare locating in the U.S. to locating a facility in Canada:

	United States	Canada
1. Depreciation on facility	\$2,400,000	
2. Deduction of facility in year acquired		\$20,000,000
3. Deduction R&D expenses	10,000,000	10,000,000
4. Additional deduction allowable for 50 percent of the excess of current expenditures over 3 prior years' average		15,000,000
5. Total deduction	12,400,000	45,000,000
6. Less credit allowed below for R&D in Canada		(3,000,000)
7. Net deduction	12,400,000	42,000,000
8. Tax reductions at 46 percent rate	5,704,000	19,320,000
9. R&D credit ¹	2,500,000	3,000,000
10. 861 effect on foreign tax credit ¹	(644,000)	
Net tax reduction for R&D	7,560,000	22,320,000
U.S. net tax reduction for R&D		7,560,000
11. Tax benefit in Canada in excess of U.S. benefit		14,760,000

¹ Section 861 effect on foreign tax credit, assume 20 percent foreign sales and excess foreign tax credits: Total R&D, \$10,000,000; less 30 percent to United States, (\$3,000,000); balance, \$7,000,000; 20 percent to foreign, \$1,400,000; reduced limitation (46 percent of \$1,400,000), \$644,000.

Analysis of \$14,760,000 benefit

	Canadian tax benefit
1. Timing difference on immediate expensing of building instead of depreciating over 15 years	\$8,096,000
2. Deduction for R&D expenses in excess of prior 3 years' average	6,900,000
3. R&D credit	(880,000)
4. 861 Effect in U.S. for R&D allocated to foreign source income	644,000
Total net Canadian tax benefit	14,760,000

Mr. ANTHONY. Thank you.
Mr. Cherecwich.

STATEMENT OF PAUL CHERECWICH, JR., TAX MANAGER, THE FOXBORO CO., ON BEHALF OF THE AMERICAN ELECTRONICS ASSOCIATION, THE SCIENTIFIC APPARATUS MAKERS ASSOCIATION, AND THE SEMICONDUCTOR INDUSTRY ASSOCIATION

Mr. CHERECWICH. Good morning. I am Paul Cherecwich, I am the corporate tax manager of the Foxboro Co., a manufacturer of process management and control instruments, headquartered in Foxboro, Mass. In 1982, Foxboro had a total sales volume of \$603 million. Of this amount, approximately 50 percent represented products sold outside the United States. That makes us larger than some companies but smaller than some of those that were mentioned today.

I am appearing before you today on behalf of the Scientific Apparatus Makers Association [SAMA]; the American Electronics Association [AEA]; and the Semiconductor Industry Association [SIA].

SAMA is a national trade association representing this country's manufacturers and distributors of a wide range of scientific, industrial and medical instruments and equipment. SAMA members include 180 different companies, many of which are small or moderate in size. These companies constitute the bulk of American industry producing research, laboratory, analytical, electronic, test and measurement, and process measurement and control instruments, as well as a wide range of laboratory apparatus and equipment.

AEA is an association of high technology electronics companies representing all segments of the electronics industries. AEA has over 2,300 members nationwide. AEA companies account for 63 percent of the worldwide sales of U.S.-based electronics companies.

Approximately 80 percent of AEA companies are small businesses employing fewer than 200 people; 12 percent are large companies employing more than 1,000 people.

We can summarize by saying that all firms I am representing are research-intensive with substantial operations outside the United States. Because of that unique position all three firms supported the original 861 moratorium and now support making that permanent.

The 861 allocation rules impact firms in excess foreign tax credit positions, not all in all years but most firms in some years. The result as has been explained by others is that there is no current U.S. tax benefit for allocated R&D. This has two consequences which I would like to illustrate with specific reference to my own company.

First, we believe the regulation to be an investment disincentive. In my tax returns as filed in 1979 and 1980 I had excess tax credits. Those credits were greater than the increase in R&D in those years.

If we had kept our R&D in 1979 and 1980 at the 1978 levels, then we would not have had excess foreign tax credits.

In my way of looking at it, that is the same thing as denying me a deduction for the increase in R&D. The loss of credits was directly related to the R&D increase.

The second consequence of this regulation is an incentive to move abroad. In fact, in 1980 my company established a European technology operation in the United Kingdom and the Netherlands to conduct research and development. We had several reasons for establishing this operation. The primary reason was a shortage of key technical skills in the United States. However, the disincentive found in the 861-8 regulations had a bearing in this decision. The move was easy to make.

We had an infrastructure in place because we had built factories where our customers were located, so we already had a payroll department to process payroll, and desks and chairs, et cetera. Communications were quite easy with satellite links enabling our people to talk easily back and forth. So a very feasible business decision turned out to have a significantly advantageous tax viewpoint.

It is interesting that other countries offer incentives. Mr. Hardiek talked about Canada. In the text of my formal testimony is a memorandum I received at the end of the summer from my col-

league in Australia. The Foxboro Co. has a 100-percent-owned subsidiary in Australia.

My colleague has written to me asking my assistance in explaining to management the benefits of transferring R&D projects to Australia. He has no idea about loss of credits or 861-8 disincentives. He just points out how beneficial it would be from an Australian view point if we moved some R&D into Australia.

Although I am not asking Congress to match the Australian incentives, I think the least we can do is eliminate the 861-8 disincentive.

The notice of the hearing said that the panel would like to hear about transfers of technology. And I have not heard anyone else talk about that this morning. Transfers of technology under section 367 I submit is not relevant to this discussion. The high technology industries are characterized by being evolutionary in their product development, not revolutionary. This evolutionary product development means that technology flow is continuous. Thus the technology that does go abroad goes abroad under arm's-length licensing arrangements under section 482. The technology is generally not contributed to foreign manufacturing affiliates and just used in only one location; it is used throughout the world.

In conclusion, I note that in 1981 Congress said that R&D in the United States must be encouraged. Thus they passed the R&D credit and they suspended the R&D allocation rules under section 861-8. This R&D credit is clearly the most important incentive that we have, but we also urge that the disincentive be removed permanently.

Mr. Rangel indicated in a number of his questions that he thought it would be more appropriate just to do something with the credit. Unfortunately, if that were the case, the impact of the 861-8 allocations would not hit everyone uniformly.

I just filed my 1982 tax return on September 15, and in anticipation of coming down to Washington I did some pencil-pushing to find out what the moratorium was worth to my company. In fact, the moratorium was equal to approximately 75 percent of the R&D credit that we claimed. In other words, that R&D credit would not have been a useful incentive in terms of the budget-setting process that is now going on for 1984 and 1985 if we could not also say that the disincentive had been removed.

Thank you very much.

[The prepared statement of Mr. Cherecwich follows:]

STATEMENT OF PAUL CHERECWICH, JR., TAX MANAGER, THE FOXBORO CO., ON BEHALF OF AMERICAN ELECTRONICS ASSOCIATION; SCIENTIFIC APPARATUS MAKERS ASSOCIATION; AND SEMICONDUCTOR INDUSTRY ASSOCIATION

My name is Paul Cherecwich, Jr. I am the Corporate Tax Manager of The Foxboro Company, a manufacturer of process management and control instruments, headquartered in Foxboro, Massachusetts. In 1982, Foxboro had a total sales volume of \$603 million. Of this amount, approximately 50 percent represented products sold outside the United States.

I am appearing before you today on behalf of the Scientific Apparatus Makers Association (SAMA), the American Electronics Association (AEA), and the Semiconductor Industry Association (SIA).

SAMA is a national trade association representing this country's manufacturers and distributors of a wide range of scientific, industrial and medical instruments and equipment. SAMA members include 180 different companies, many of which

are small or moderate in size. These companies constitute the bulk of American industry producing research, laboratory, analytical, electronic, test and measurement, and process measurement and control instruments, as well as a wide range of laboratory apparatus and equipment.

AEA is an association of high technology electronics companies representing all segments of the electronics industries. AEA has over 2,300 members nationwide. AEA companies account for 63 percent of the worldwide sales of U.S.-based electronics companies. Approximately eighty percent of AEA companies are small businesses employing fewer than 200 people; twelve percent are large companies employing more than 1,000 people.

SIA is the trade association of those electronics companies which manufacture integrated circuits and other semiconductor products. These products are the basic building blocks of most high technology electronics products. SIA has 56 member companies, which have well over \$8 billion in sales of semiconductor products.

High technology companies generally, and members of AEA, SAMA and SIA in particular, are intensively research and development oriented. On average, companies in the electronics industries invest between 6 and 7 percent of their sales on R&D. My own company spent 7.2 percent of sales on R&D in 1982. In some electronics industries, for example, semiconductor manufacturing companies, as much as 10 to 12 percent of revenues are spent on R&D. Thus, for all segments of the electronics industries the tax treatment of R&D expenditures is of crucial importance.

Moreover, U.S. high technology electronics companies generally have extensive international operations. U.S. electronics companies generally have worldwide sales of about \$250 billion in 1982, of which almost \$100 billion are from sales in foreign markets. Moreover, about 18 percent of the electronics products produced in the United States are exported. Nearly one electronics job in five depends directly on exports.

Because high technology electronics companies are research-intensive and have a substantial portion of their operations outside the United States, AEA, SAMA and SIA in 1981 supported the moratorium on Regulation 1.861-8 and now support efforts for its extension in the future.¹

IMPACT OF REGULATION 1.861-8 ON R&D INVESTMENT DECISIONS

The allocation of R&D expenses to foreign income under Regulation 1.861-8 has its primary impact on companies which are in an excess foreign tax credit position. That is, companies which pay a sufficiently high level of foreign taxes that their overall average foreign tax rate on foreign income subject to U.S. tax equals or exceeds the U.S. statutory rate of 46 percent. Not all electronics companies are in an excess foreign tax credit position in any year. However, many electronics companies are in that position in some years, and some companies are in that position almost every year.

For any taxpayer in this position the effect of the allocation of R&D expenses to foreign income under Regulation 1.861-8 is clear: the taxpayer receives no current U.S. tax benefit from the allocated R&D expense. Moreover, even though the United States allocates the expense to foreign income, foreign governments do not in an equivalent manner treat the expense as deductible against their own income tax. Thus, no current benefit is received from R&D expenses allocated to foreign source income by these taxpayers in any jurisdiction. The current after-tax cost of a dollar of research expenditures incurred in the United States allocated to foreign income is a dollar—not the 54 cents which normally represents the after-tax cost of R&D expenditures incurred in the United States.

Two important consequences result from this increased cost of R&D. First, the increased cost provides a disincentive for U.S. companies to invest in R&D in the United States. In 1979 and 1980, for example, my company had excess foreign tax credits which it could not use in its tax returns as originally filed. We would not have had those unused credits if R&D spending had remained at 1978 levels. In fact, the operation of Regulation 1.861-8 was such that in 1979 and 1980 the increase in R&D expenses allocated to foreign source income grew even faster than the underlying rate of growth of our overall R&D budget. This increased apportionment to foreign source income further reduced our usable foreign tax credit and thereby increased the cost of undertaking increased R&D in the United States.

Based on my company's example, it can be seen that the more a company in research-intensive industries spends on R&D, the more foreign tax credit it loses. This

¹In particular, the associations support H.R. 1887, which would make the moratorium permanent.

can be the equivalent of denying a deduction for R&D for those firms that are taking the steps necessary to promote R&D exports and create U.S. jobs by undertaking high levels of R&D. U.S. corporations that invest heavily in R&D and compete vigorously in world markets should not be penalized for doing so.

A second consequence of the allocation of R&D expenses under Regulation 1.861-8 is that it provides an incentive for U.S. taxpayers to perform R&D outside of the United States. Once again, my own company provides a case in point. For many years, Foxboro tended to centralize all of its R&D efforts in the United States. However, in 1980 a decision was made to establish a European R&D operation. The Foxboro Company now has R&D activities underway in its subsidiaries in both the Netherlands and the United Kingdom as well as in the United States. Our reasons for relocating these activities were a combination of shortages of key technical skills in the United States, U.S. tax penalties, and other factors. We already had a support infrastructure in place in Europe and have found no difficulties in directing and coordinating this activity from the United States, thanks in part to the ease of communications via telephone, telex, computer links and personal visits. Thus, the decision to expand R&D operations abroad rather than in the United States was from a business point of view entirely feasible and from a tax point of view clearly advantageous. I believe other companies like Foxboro will move R&D operations outside the United States if their reduced tax benefits on R&D were to become substantial through the renewed application of Regulation 1.861-8. As our experience indicates, for many companies moving R&D to other developed countries is relatively easy.

As an aside, I would like to note that, as I mentioned above, shortages of key technical personnel were a major factor in our decision to relocate abroad. While this problem is not addressed by the moratorium on R&D allocations, it is addressed in a very positive manner by H.R. 3095 introduced by Mr. Shannon and others and H.R. 3098 introduced by Mr. Stark and others. These bills have been endorsed by all three associations I am representing and are a high priority for enactment in 1984. We hope the Ways and Means Committee will consider them early in the next session.

Given the impact of Regulation 1.861-8 as described above, if it were reinstated, the United States would impose a tax penalty on some U.S. companies performing research in the United States at the same time that foreign governments are doing all in their power to provide incentives for the performance of research in their countries. Attached to this testimony is a memorandum received from an employee of my firm's Australian subsidiary. The employee points out that research and development grants are available and suggests that some of the work now performed in the United States be performed in Australia to take advantage of these incentives. The attached example is not an isolated one. In my own experience numerous countries offer tax and other incentives in an attempt to attract research facilities from high technology companies. Surely it is in the interest of the United States, if not to match these incentives, at least not to provide the kinds of disincentives which can result if Regulation 1.861-8 were reinstated.

REGULATION 1.861-8 AND TRANSFERS OF TECHNOLOGY ABROAD

The notice for this hearing stated that the subcommittee would be examining, among other things, whether the moratorium on Regulation 1.861-8 provides an incentive to make tax-free transfer of technology for use in manufacturing operations abroad. In my view the potential application of Regulation 1.861-8 is essentially not relevant to issues relating to the contribution of technology for manufacturing abroad. In the electronics industries at least the ownership of technology is generally not transferred to a foreign manufacturing affiliate by the company (for example, the U.S. parent) which is undertaking the underlying R&D. Instead, the owner of the technology licenses it to the manufacturing affiliate and in return receives royalty payments. The licensing agreement is subject to the arm's-length standards of Section 482 of the Internal Revenue Code, thereby assuring that the proper amount of income is received by the company owning the technology.

In the electronics industries technology is generally licensed rather than contributed to foreign manufacturing affiliates for at least two reasons. First, the electronics industries are properly characterized as one in which product development is evolutionary rather than revolutionary. Thus, technology is developed as a continuous process, and typically must be transferred to foreign manufacturing subsidiaries in a continuing process. To meet this business need, the most appropriate legal arrangement is an overall and continuing license of all technology relevant to the foreign manufacturing affiliate's products. In this way, the affiliate obtains on a con-

tinuous basis all new technology relevant to its operations. If the foreign affiliate did not receive this technology continuously, it could not meet its foreign competitors which are generating new technology on a continuing basis.

In addition, technology is generally not contributed to foreign manufacturing affiliates because the technology relates not only to products manufactured by that company but to products manufactured by other members of the affiliated group around the world. Obviously, if their affiliated companies are utilizing the same technology in products they manufacture, not all of these affiliates can own that technology. In such a case the most logical method of operation is for the company developing the technology to own it and license its use to each of the manufacturing affiliates. That is a typical pattern of operations in the electronics industries. The moratorium on allocating R&D expenditures to foreign sources in no way provides an incentive to alter these arrangements.

CONCLUSION

Congress and the Administration have in recent years spoken loudly and clearly with regard to the importance of U.S. research and development activities. It is, I think, now the established policy of the United States that R&D activities in this country must be encouraged to maintain the technological edge and its competitiveness of U.S. companies in both U.S. and foreign markets. In 1981 that policy was implemented in the Tax Code by the enactment of the R&D credit and the moratorium on Regulation 1.861-8. The R&D tax credit is clearly the most important of two measures; it provides a major incentive for virtually every electronics company undertaking research in the United States. However, even though it affects only some electronics companies, the moratorium on Regulation 1.861-8 is also important. Congress should not now turn away from the policies established in 1981 by failing to extend the moratorium on Regulation 1.861-8.

AUGUST 20, 1983.

To: P. Cherecwich Jr. D.111 Foxmass,
From: J. R. Boag—Lilydale, Australia.
File: Industry research & development grants.
Subject: Systems projects.

PAUL: You may not be aware that there are certain incentives for industrial research and development in Australia which result mainly in cash grants, providing various rules are followed.

Robert McInnes has suggested that there are a number of projects in the Systems area which could be performed at Lilydale, and if so, could result in us obtaining I.R. & D. grants.

The Labour governments, both Federal and State, are very keen to promote high technology in Australia and are making it easier to obtain funds to develop suitable programs.

It seems that although senior management at Foxboro has agreed in principle that Lilydale people could provide a Corporate service by carrying out various development work, it seems that the middle management area in the United States has bogged down decisions which should be made before we can commence doing anything.

In view of the possibility of receiving I.R. & D. grants, is there anything you could do to assist us in initiating some type of program?

Regards,

S. RAWSON,
(J. R. BOAG).

Mr. ANTHONY. I would like for you to go to page 5 of your testimony. I am going to address this question to both of you. I didn't highlight anything in Mr. Hardiek's testimony that hit on this, but it is a question that seems to stand out.

The question is what factors will management and firm financial analysts take into account in determining when and where to expand R&D activities? And where do the source allocations rules fit in?

How important is the allocation to firm decisions?

What triggers that question is, of the three factors that you list, U.S. tax penalties is only one factor in making your decision. You

use key technical skills in the United States, and then you mention other factors. I wish you would expand on the other factors so I could clarify in my own mind and for the record just how important the penalty is in that corporate decision.

Mr. CHERECWICH. The penalty was not the primary motivating factor, I must be honest in saying. We were having a problem in the United States finding key technical people. We believed that there was a pool of technical people available in Europe. We already had facilities in Europe, because we had gone and put our factories where our customers were.

Since the nature of our product is such that we require engineering staffs to help our customers apply the products to their facilities, we had some engineering people already on the payroll, and we found that we were losing some of those people because they felt there was no long-term career growth for them in those locations.

So one of the other factors that was a consideration in moving was to provide a career growth opportunity for the people that we did have, that we did not want to lose. That was low down on the list.

The main reason for moving abroad was a shortage of key technical skills. If you were to talk to one of our personnel people, they would say that the next key factor was providing a career path for the employees that we had in Europe. If you talked to one of our financial or tax people, they would have said the next key motivating factor was the numbers. Thus, priority reasons depend on who you are talking to and who is the advocate in an organization.

I can just tell you that when there was discussion going on that I began to hear about, when I heard, "Maybe we ought to do something; maybe we should go abroad," I immediately piped up with, "Have you realized what a tremendous tax advantage that would be?" And I then argued that would be an appropriate move to make in terms of the bottom line impact on our reported earnings to our shareholders.

Mr. ANTHONY. Let me rephrase the question in light of your answer.

Suppose this bill was passed into law, and that there was a permanent change on 861. You are confronted with an identical set of factors. Now you are forced with making that same decision. Do you think those other factors are so compelling that there is a great likelihood that your company would have moved anyway?

Mr. CHERECWICH. I think if you changed the whole set of economic factors, where we now have the section 44F credit so it can be argued that increased expenditures on R&D in the United States are in part paid for by the use of the credit and we lose that opportunity if we go abroad, that loss would be weighed against the ability to find the people in the United States. Finding the people is still an important issue.

I honestly cannot tell you whether or not we would expand or contract the operation. We have approximately 60 people between the Dutch facility and the British facility at this point. I strongly suspect that we would not contract that. The issue for the future is more how much do we expand it? I would like to point out that it is relatively easy to establish an R&D operation abroad if you are

the kind of company that already has facilities abroad, and the kind of company that has facilities in high-tax-rate countries, such as Holland and England, are going to run into excess tax credit limitation positions and the whole thing sort of comes full circle and it feeds on one another. Thus firms with excess foreign tax credits are in that position because they have facilities abroad, and they can solve part of their problems by easily establishing R&D operations in those facilities.

Companies that have facilities in tax holiday countries are not going to have any excess tax credit positions. Even though those firms are not going to want to establish R&D facilities in tax holiday countries, they don't have to because they don't have a tax credit problem.

Mr. ANTHONY. Both of you are in an excess foreign tax credit position. To what extent does the foreign tax credit carryforward and carryback rules assist your excess credit problem?

Mr. CHERECWICH. It helped me in 1979 and 1980. I am afraid that in 1983 we are not doing very well economically. And when one is not doing very well economically, all of a sudden a 2-year carryback becomes extremely important, because there is the routine repatriation of funds from abroad every year that carry with them foreign tax credits. Frankly, if we did not have the suspension, I would be in some deep cash flow trouble right now.

Mr. ANTHONY. A final question. Then I will yield to Mr. Martin.

How does your firm report R&D expenses for its internal accounting purposes and to what extent are foreign subsidiaries, now that you have one established, charged with the R&D expense in terms of local evaluation of performance, since the R&D in fact is directed from the United States.

Mr. CHERECWICH. That R&D is all consolidated for financial reporting purposes to the SEC. Internally, no local manager is charged with R&D expense for performance evaluation purposes.

Mr. ANTHONY. Mr. Hardiek, do you have any comments you would like to make based on those series of questions?

And then, Mr. Martin, you are recognized.

Mr. HARDIEK. It seems to me that one of the things that we are missing in the whole concept of the incentive or disincentive is the fact that when R&D is allocated against the foreign source income, it does reduce the limitation. And to that extent, when Deere operates in Germany, and Germany does have a high tax rate, Deere has been taxed once in Germany and again in the United States. And then the tax credit on the German taxes is not allowed in the United States because of the fact that you have allocated this R&D against that foreign source income.

So it seems to me it also comes down to a matter of fairness. Is it fair to allocate that R&D against the foreign source income and thereby result in a reduced foreign tax credit so that a company is paying tax twice on the income earned in Germany?

In answer to your last question, Deere & Co. has not benefited from the foreign tax credit carry-forward. We have had excess foreign tax credits since 1978, and because of some 904(f) provisions, it appears as though we will have some excess foreign tax credits in future years.

Mr. ANTHONY. Mr. Martin?

Mr. MARTIN. Thank you, Mr. Chairman.

Mr. Hardiek, in looking at your testimony and the exhibit A you included, there are some questions that I would like you to answer.

First of all, in determining the comparison between the tax treatment of the new \$20 million facility in the United States and Canada, you show under item 2 the immediate deduction of the entire cost as an expense, which is allowed in Canada, and you show only the first year's depreciation as allowed in the United States, the first of 15 years depreciation that would be allowed in the United States. Isn't there some, what the economists call, present value to the remaining depreciation, and shouldn't you in fairness take that into account? Don't you consider that in determining whether you are going to build a facility?

Mr. HARDIEK. You are absolutely correct.

Down at the bottom I have tried to show that in terms of the timing difference, that the \$8 million which is really the 20 million times the tax rate—\$8.96 million is really a timing difference. So, yes, it could have been expressed another way in terms of asking what is the present value of the tax effect of deducting it in 1 year versus deducting it over 15 years. But you are absolutely right, a timing difference has less significance by quite a bit than a permanent tax difference.

Mr. MARTIN. If that \$8 million figure is the present value of the depreciation in the United States which is not taken in the first year, then it would seem to me that in fairness that reduces the relative advantage of making the investment in Canada by roughly \$8 million, because that is a part of your consideration, that is an asset on the value of that future—

Mr. HARDIEK. I am sorry, not actually present value. The \$8.96 million is not a present value figure. That is just 46 percent of that amount.

Mr. MARTIN. Roughly two-thirds of that?

Mr. HARDIEK. I would say half.

Mr. MARTIN. There would be some reduction of \$4 to \$6 million?

Mr. HARDIEK. That is right.

Mr. MARTIN. That still leaves you somewhere on the order of \$10 million advantage for making the investment in Canada, even taking that present value into account. If that is so—

Mr. HARDIEK. That is on the first year.

Mr. MARTIN. But that is first year, taking into account what the future depreciation in the United States is worth to you.

Now, that is still a \$10 million advantage to making the investment in Canada. Why do you have 90 percent of your research in the United States? Why have you not made it in Canada?

Mr. HARDIEK. Well, we are looking at that, and when I first looked at this situation, the farm equipment business was very good. As you are probably aware, at the present time it is not very good, and we are not in a position to be expanding R&D facilities. If anything, we are contracting those facilities. Once the farm equipment business rebounds, we will give additional consideration to these computations to see whether it does make sense to put the facility in Canada.

The real purpose of bringing this computation out was not of looking at it just from a Deere & Co. standpoint, but to make you

aware of what other companies as well as Deere & Co. are doing and must do any time they decide whether to expand a research facility in the United States or whether it ought to be done in another country.

Mr. MARTIN. You indicated you are spending about \$242 million a year for research anyway. What you are now saying is that is not an expanded program, that is a reduced program, and some of that is contracted for other people's research?

Mr. HARDIEK. I am saying we are merely reducing the amount of R&D that we do worldwide. Most of that reduction of course is coming in the United States.

Mr. MARTIN. Item 10, you include the effect of the 1.861-8 regulations which is developed below. But you include the effect of that on line 10 as being \$644,000. That is relatively small, but it is in proportion to the percentage of your sales which are overseas, is that correct?

You are assuming 20 percent?

Mr. HARDIEK. That is correct.

Mr. MARTIN. Twenty percent of your sales overseas. Therefore, that would be larger for a company that had 60 percent of its sales.

Mr. HARDIEK. That is right. If it were 60 percent, it would have doubled.

Mr. MARTIN. But in relation to—60 percent triples it.

Mr. HARDIEK. Yes, I am sorry, you are correct.

Mr. MARTIN. In any case, the figure that you show there is relatively small in comparison, that is \$644,000 is relatively small in comparison with the \$10 to \$14 million of disadvantage. And I guess that leads me to ask whether this 861-8 regulation is all that potent a factor by itself.

Mr. HARDIEK. Well, you are looking at a study here done on Canada, and it is done on one facility. But it may be a much closer comparison when you look at France, Spain, Germany or the United Kingdom. I think Canada has been a leader in terms of countries that have tried to encourage more R&D in their country.

For example, they have currently a proposal which would allow a 20-percent R&D credit on all R&D expenses, not only incremental R&D. So I think we are looking at a country here that is probably a leader in this respect—if you were making comparisons with other European countries, it might appear to be much bigger by comparison.

Mr. MARTIN. Thank you.

Mr. ANTHONY. Just one final question.

For purposes of determining a U.S. company's net worth in reporting to its stockholders, that is U.S. stockholders, is all of the R&D expense allocated against the United States income?

Mr. CHERECWICH. Sir, in our annual report in the footnotes we break down results between U.S. operations, foreign operations, and something that we call corporate. All of the R&D is included in the so-called corporate expense to distinguish it from general operating expense, and R&D is not broken out as to where it took place.

Mr. ANTHONY. OK.

The Oversight Subcommittee would like to thank both of you for your testimony and for helping us with these very complex issues.

Inasmuch as I represent a farming community, I have seen a lot of John Deere tractors. I hope your company and the farming community both can help so you can do a lot more R&D, make more tractors, and my farmers can buy more of them.

We will take a recess now to vote.

[Recess.]

Mr. ANTHONY. The subcommittee will resume.

Our next panel consists of Mr. Robert S. McIntyre, director, Federal tax policy, Citizens for Tax Justice, and we have Mr. Robert McGarrah, director of public policy, American Federation of State, County & Municipal Employees, AFL-CIO.

STATEMENT OF ROBERT S. MCINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE

Mr. MCINTYRE. Thank you, Mr. Chairman. I appreciate the opportunity to be here on behalf of Citizens for Tax Justice.

Our coalition of labor, public interest, and citizens groups represents tens of millions of Americans who are very concerned about the kinds of issues which are being raised today, which involve both tax fairness and how the tax laws affect employment and economic growth in the United States.

I would like in summarizing my statement to expand the discussion we have been hearing today and to give a rather different slant to some of the things that have been said.

As you know, the United States gives very large tax incentives for companies to do research and development in the United States. In effect, the Federal Government allows writeoffs and credits that pay for, at least in the first year, somewhere between 46 and 71 percent of the costs of research and development incurred in this country.

Now, the payoff for that is supposed to be increased economic growth, more jobs in the United States, and a healthier economy generally.

Unfortunately, however the Federal Government also gives very large tax incentives for companies to move overseas the production jobs that result from their U.S. R&D. If, for example, a company sets up production in a low-tax foreign country, we typically will let the fruits of the company's research and development be shipped offshore with little or no tax penalty, and we will exempt the company's foreign income from U.S. tax indefinitely.

Moreover, if a company sets up production in a high-tax foreign country, the U.S. Government, at least under the current rules, will agree to pay some of the company's foreign taxes.

The low-tax country problem has received most of the attention recently. We have all read about Atari, Apple, Mattel, Hewlett-Packard, and other companies moving to the Far East, Mexico, and other places where they find both low wages and tax advantages.

I am heartened to see that the tax reform proposal recently put forward by Representatives Gephardt, Pease, and others for consideration on the House floor soon includes some measures which would try to curb the tax incentives for companies to move to these low-tax countries. Under that amendment, deferral of tax on foreign profits would be eliminated, the ability of companies to ship

the fruits of their R&D abroad tax-free would be eliminated, and so forth. We support these reforms, because we care about American production jobs. If Congress is to sustain its hope that the R&D incentives in the Tax Code will help create jobs, it needs to take these kinds of steps.

Let me move on here to the 861-8 issue, which has been the focus of most of the testimony today. Although the moratorium on the 861-8 rules affects only American firms operating in foreign countries with high rates of taxation, the basic question here, as we see it, is conceptually similar to the issue with regard to companies that export jobs to low-tax countries: Does it make sense to provide tax incentives for American companies to use the fruits of their U.S.-performed, tax-subsidized R&D to create income and jobs abroad? In other words, do we want to subsidize foreign production, which is what the moratorium in effect does?

Some of the witnesses here today have suggested that the 861-8 rules now suspended, are too tough, that they allocate too large a share of a company's R&D expenses to foreign-source income. We find that to be a very hard position for anyone to sustain. If you look at the mechanics of the rules, you will find, for example, that when a company has half of its sales here in the United States and half abroad, the maximum foreign allocation of R&D expense will be only 17.5 percent of the total. In many cases it will be far lower, because companies are allowed to show that their American R&D does not benefit foreign production, and if they make that showing they can reduce their foreign allocation even further.

Companies also have said that we need to retain the moratorium's incentive to move production jobs abroad because otherwise we will lose R&D in the United States.

They suggest that if the 861-8 regulations were put back into effect, we would see a shifting in R&D abroad. Well, the Treasury Department has done some theoretical analysis and has cited a number of studies that have surveyed companies. The conclusion of all has been that the incentive to shift R&D abroad from the 861-8 regulations is trivial at most because it is outweighed by other factors which encourage companies to keep their R&D here in most cases.

It is also helpful to take a look at the data. In the 5 years that the 861-8 regulations were on the books, we find that the U.S. share of total R&D engaged in by American companies and their foreign affiliates went way up. We find that U.S. R&D increased 50 percent faster than R&D by foreign affiliates. So the data does not support any claim that we were losing R&D because of the 861-8 provisions. On the other hand, it does seem to us very likely that we may lose production jobs if the 861-8 rules remain suspended.

So in conclusion, I want to say that we hope Congress will go forward with the reform proposals that have recently been made to deal with the tax incentives to shift jobs to low-tax foreign countries.

We also hope that the 861-8 regulations will be allowed to go back into effect. And we urge the Treasury Department to take another look at these regulations and strengthen them so they do the job they are supposed to do, which is to make sure that American

companies don't get Uncle Sam in the position of paying some of their foreign taxes for them.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROBERT S. MCINTYRE, DIRECTOR, FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE

I appreciate the opportunity to appear before the Subcommittee today on behalf of Citizens for Tax Justice. Our coalition of labor, public interest, and citizens groups represents tens of millions of average American taxpayers, who have a vital interest in assuring that the tax laws are fair and that they do not adversely affect employment and economic growth in the United States.

Our testimony today concerns certain provisions of the U.S. tax laws that grant special tax advantages to companies that engage in research and development in the United States and use the fruits of that R&D to support foreign manufacturing operations. It is our conclusion that these provisions violate sound tax policy principles, provide unwarranted tax benefits to some U.S. multinational corporations at the expense of average taxpayers, and create incentives for companies performing R&D in the United States to shift their manufacturing operations overseas. Our principal policy recommendations are:

1. Congress should consider ending the deferral of federal income tax on the overseas profits of subsidiaries of American corporations, in particular for income earned from operations in foreign countries with very low rates of taxation. A less dramatic, but helpful first step would be to require that companies that transfer the fruits of their U.S.-performed R&D to foreign subsidiaries do so by licensing agreements or other means that assure that the income the R&D generates abroad is subject to current U.S. taxation.

2. The moratorium on IRS enforcement of its 861-8(e) regulations, which govern apportionment of R&D expenses between domestic- and foreign-source income for purposes of the foreign tax credit limitation, should be allowed to expire. Moreover the Treasury Department should amend the regulations so that a fairer (and larger) proportion of R&D costs is apportioned to foreign-source income in most cases.

INTRODUCTION

When an American company performs R&D in the United States, the federal government provides the firm with an immediate tax deduction for the costs incurred, plus a 25 percent tax credit in certain cases. As a result, the government becomes a partner, sometimes the major one, in private R&D investments. For a corporation in the 46 percent tax bracket, the out-of-pocket, after-tax cost of \$1 worth of R&D will be no higher than 54 cents and sometimes will be as low as 29 cents.¹ The remainder is put up by the government.

In return for its "investment," the government expects to share in the future profits (if any) that the R&D generates. Assuming that those profits are taxable, the government's profit share will be 46 percent. This is exactly equal to the government's share of the original R&D investment in situations where the R&D is not eligible for the 25 percent tax credit. Where the credit applies, the government's 46 percent profit share will be substantially less than its 71 percent share of the initial investment.

This cost-sharing/profit-sharing approach is intended as a government incentive for private R&D. In effect, the government agrees to exempt from tax or even subsidize the profits from R&D investments in hopes of stimulating greater private spending on R&D.²

¹ The tax deduction for research and development expenses saves a 46-percent-bracket corporation 46 cents for every dollar invested in R&D, leaving its out-of-pocket cost for each \$1 in R&D at 54 cents. If applicable, the 25 percent tax credit for incremental research and experimental expenses will bring the total tax savings from \$1 in R&D to 71 cents, leaving the company's out-of-pocket cost at only 29 cents for a dollar's worth of R&D. These calculations do not include tax savings at the state level, which could add another 4-5 cents in tax savings (after accounting for the deductibility of state taxes on the federal return) for each dollar invested in R&D.

² As is illustrated in the example in section A below, the effective tax rate on profits from R&D investments can be substantially below zero; that is, "negative" tax rates are sometimes provided.

From a company's point of view, the benefits of this system are obvious. From the government and the public's point of view, the hoped-for additions to R&D spending are expected to yield greater prosperity, more U.S. jobs, improved international competitiveness, and so forth.

Whether the tax incentives for R&D are effective or efficient in achieving these goals has been called into question by many, including ourselves. Putting that issue aside, however, we want to focus on situations in which companies have been able to use the fruits of their U.S.-performed R&D to support foreign manufacturing operations, while taking advantage of tax rules governing transactions with controlled foreign subsidiaries to: (a) deny the government its share of R&D-generated profits and thereby, in effect, to increase the size of the tax incentives to a much larger level than was ever intended, and, at the same time, (b) frustrate the purpose of the incentives to create added jobs in the United States.

A. Transfers of technology and jobs to low-wage, low-tax countries

The problem of high-tech firms exporting jobs to low-wage, low-tax countries is not a new one, but it came to particular national attention last February with the announcement by Atari, Inc. that it was laying off 1,700 California workers and transferring its home-computer and video-game production to Hong Kong. Last month, Atari followed up by announcing the firing of 380 employees in El Paso, Texas and the shifting of its El Paso assembly and manufacturing operations to plants in Taiwan and the far East. And, as Congressional Quarterly reported in July:

"Atari . . . is not alone. Mattel Inc. and Hewlett-Packard have also exported many of their high-tech assembly jobs; many of their video games, calculators, computer components, and fiber-optic equipment are now produced in Hong Kong and other developing countries of the Far East. Meanwhile, Apple Computer is awaiting permission from the Mexican government to open a plant in Mexico to assemble its new, top-of-the-line Apple IIe personal computers."

In May, Forbes reported that "Zenith is closing an Illinois plant that makes television parts and moving to Mexico, eliminating 600 jobs." The March 19, 1983 New York Times noted that "companies like Apple Computer and Wang Laboratories . . . have turned to the Far East for substantial preliminary assembly work on computer components." Asian jurisdictions are working hard to attract these jobs. The February 25, 1983 Christian Science Monitor stated: "Officials from Hong Kong have been in Silicon Valley, trying to lure American firms to the city. They recently invited 200 companies to a seminar—60 showed up."

Our analysis indicates that current U.S. tax rules may play a significant role in encouraging American high-tech firms to shift their manufacturing operations abroad. A simplified example can illustrate the problem. Take a company that invests \$100 in R&D, and applies the fruits of that research to production that generates income traceable to the R&D investment in the next year of \$120—after which there is no further income.

With no taxes, this means a net profit of \$20, for a 20 percent rate of return on the \$100 R&D investment.

Now, let us examine the results under current U.S. income tax rules.

If both the R&D and the production take place in the U.S., the company's initial out-of-pocket cost for the R&D will be reduced by the \$46 tax saving from the immediate write-off and, in some cases, by an additional \$25 R&D tax credit. Therefore, the initial after-tax investment will be a maximum of \$54 and a minimum of \$29. When the \$120 is earned in year two, the 46-percent tax will be \$55.20, leaving the company with \$64.80 after tax. This represents a rate of return ranging between 20 percent (on a \$54 after-tax investment) to 123.4 percent (on a \$29 after-tax investment). Thus, the company will earn at least as high a rate of return as if there were no taxes, and potentially a much higher return.

These are certainly extremely favorable tax results, but shifting the fruits of the R&D to foreign production could be even more lucrative. Suppose the production takes place in a foreign jurisdiction with a 15 percent corporate tax rate, and that all the other facts remain the same. In this case, the tax on the \$120 earned in year two will be only \$18, and the after-tax net earnings will be \$102. This represents an 88.9 percent return on a \$54 investment and a 251.7 percent return on a \$29 investment—in either case, a far higher after-tax return than from U.S. production.

By shifting its production abroad, the company in this example has denied the U.S. government any share in the profits generated by the R&D that the government helped finance by allowing generous tax write-offs. Thus, the company has obtained far larger tax benefits than were intended when the R&D tax incentives

were enacted. At the same time, the company has largely frustrated the purpose of the incentives to create U.S. jobs.

Now, some may argue that these tax breaks for foreign production, however large they may be, are not the critical factor in job opportunities being shifted overseas—that the attraction of cheap foreign labor will entice companies to head offshore with or without a U.S. tax break.

To such contentions, we have two responses. First, even if some firms would indeed move overseas without a tax subsidy, it still makes no sense for the United States to reward them for doing so. And, second, it is far from clear that tax advantages do not play a key role in at least some moves offshore.

To be sure, wage rates are lower in developing countries than in the United States. *The Christian Science Monitor* reports that “[w]ages for high tech assembly line jobs start at around \$7 in the US, compared with \$3-\$4 in Hong Kong.” According to a spokesman for the American Electronics Association, quoted in *Industry Week* in March of this year, the differential may be even larger. “Labor costs in Taiwan,” he said, “are \$2 an hour and less. In Hong Kong, wages and benefits are \$1.20.” (Which of these estimates is more accurate is largely a function of the strength of the U.S. dollar, which obviously has been very strong—much too strong—recently. The almost 50 percent run-up in the trade-weighted real exchange value of the dollar since 1980 has, in effect, reduced the relative cost of foreign labor by a third just in those three years. A more responsible federal fiscal policy, including far fewer costly tax giveaways to powerful interest groups, would obviously help stem that unwarranted advantage.)

But balanced against low foreign pay scales are a number of offsetting factors that, in the absence of tax considerations, might well tilt a company's decision in favor of keeping its manufacturing operations in the United States. Worker productivity is substantially higher in the U.S. than in developing countries. It is far easier to attract qualified production engineers here. Foreign manufacturing can entail significant transportation costs. Longer lead times that are typical of overseas production can add very substantially to inventory costs, a particular problem at a time of high real interest rates. And those long lead times mean lost flexibility and higher turnaround times, which in turn mean added risks, particularly in volatile high-tech businesses. Managing a foreign subsidiary entails added complexity and additional executive overhead costs. And the start-up expenses involved in shifting production overseas can be very substantial.

The May 23, 1983 issue of *Forbes* reports that these and other factors are significant enough that a number of companies which have tried offshore manufacturing are actually returning to the U.S. For example:

“North American Philips Corp. is gradually shifting production of its Magnavox, Sylvania and Philco chassis from Juarez, Mexico to a modern plant in Greenville, Tenn. . . . In Mexico, Philips used ‘several times’ as many workers to get the same output, says Robert Lukingbeal, senior vice president of operations.”

“RCA stopped producing surveillance cameras in Taiwan last year and moved to Lancaster, Penna. The company . . . found that integrated circuits and new manufacturing techniques more than offset the benefits that come from cheap labor, particularly after transportation and the resulting additional inventory costs were considered.”

“Motorola, meanwhile, is even bringing semiconductor production back home. . . . ‘Considering the turnaround time to get the product to our customer, the costs of air transportation and the savings that result from increased automation, we believe it is at least a break-even proposition to do assembly and test here rather than offshore,’ says Ken Phillips, a Motorola spokesman.”

Textron's Gorham division is moving its stainless-steel flatware production back to Providence, R.I. “Why did it decide to come home? Gorman had to book orders from Japan six months in advance, which hurt marketing flexibility and caused inventory buildups.”

These good news stories illustrate that it is not inevitable that U.S. manufacturing jobs will all end up overseas. But they do not mean that we should sit back and do nothing. Instead, the fact that there can be real costs as well as advantages to overseas production highlights the potential importance of tax considerations in swinging what may be a very close decision between moving abroad or staying in the U.S.

The straightforward way to wipe out most of the tax incentives that encourage companies to shift manufacturing operations to low-tax foreign countries would be to end the deferral of U.S. taxes on the earnings of foreign subsidiaries of U.S. companies. Were that step taken, the tax advantage for foreign production in the simple example described earlier would disappear, since the company's overall tax rate

would be the same for foreign production as for U.S. production. We recommend strongly that Congress consider repealing deferral—at least for American companies operating in low-tax foreign jurisdictions.

Short of repealing deferral, Congress should at least reexamine the effectiveness of section 367 of the tax code, which is supposed to impose some restrictions on the tax-free transfer of technology abroad to support foreign manufacturing operations. The IRS regulations issued pursuant to section 367 have been widely criticized as being extremely difficult to administer and largely ineffective in achieving the goals of the statute. For example, if a foreign subsidiary produces goods to be sold in U.S. markets, the section 367 regulations provide that generally the U.S. parent company will be taxed on the value of patents and other "know-how" transferred to the subsidiary. In practice, however, valuation problems make this "toll charge" approach very hard to administer fairly and effectively. And companies have an understandably strong incentive to use every available means to obtain the lowest possible tax valuation on transferred know-how.

Moreover, for no apparent good reason, if the overseas manufacturing is of goods to be sold in foreign markets, the regulations provide for no section-367 "toll charge" at all on transfers of know-how to a foreign subsidiary.

Strengthening the section 367 regulations, by covering transfers of know-how that relates to foreign sales, and by trying to improve the "toll charge" valuation procedure, might be helpful. But a more fruitful approach could be to require that companies that transfer the fruits of their R&D to foreign subsidiaries do so by licensing arrangements or other means that assure that the portion of foreign production income relating to transferred R&D is subject to U.S. taxation as it is earned. In effect, what we are suggesting here is quite similar to the rules adopted in 1982 to stem abuses by companies transferring "intangible" assets like patents to Puerto Rico to take unwarranted advantage of the possessions tax credit.

B. Transfers of technology and jobs to high-tax, developed countries: The 861-8(e) regulations issue

When an American company sets up a manufacturing plant in a high-tax, developed country, the ability to defer U.S. taxes on foreign income is not usually of major concern. The foreign profits usually will be subject to current taxation by the foreign jurisdiction, typically at a rate similar to or even higher than the U.S. rate. When and if those profits become nominally subject to U.S. taxation, they will be eligible for relief through the foreign tax credit mechanism.

The foreign tax credit is intended to forgive U.S. tax on foreign-generated income to the extent that the foreign profits have already been subject to taxation by another government. Obviously, however, the foreign tax credit is not intended to reduce taxes due on profits earned in the United States. Put another way, a company is not supposed to be better off under the foreign tax credit than it would be if the U.S. simply exempted its foreign-source income from taxation.

In order to restrict the benefit from the foreign tax credit to exemption from U.S. tax, the corporate foreign tax credit is limited to 46 percent of foreign-source income.³ To calculate this limit, there need to be rules to differentiate domestic gross income and the costs of producing it from foreign gross income and the costs of producing it. One of the mechanisms for making these distinctions on the cost side involves the 861-8(e) regulations.

The 861-8(e) regulations require an apportionment of R&D expenses between domestic- and foreign-source income for purposes of computing net foreign-source income and, in turn, for calculating the limit on the foreign tax credit. (Even if the United States exempted foreign-source income from taxation entirely, similar rules would be necessary, since, presumably, such a tax system would not allow deductions against domestic profits for the cost of producing tax-exempt foreign income.)

In 1981, Congress suspended the application of the 861-8(e) regulations and provided that until the end of 1983 all costs of R&D incurred in the United States would be treated as expenses of earning U.S.-source income for foreign tax credit purposes. One of the purposes of this hearing is to explore whether that moratorium on enforcement of the 861-8(e) regulations should be allowed to expire. For the rea-

³ A simple example can illustrate how allowing a foreign tax credit for more than 46 percent of foreign-source income means that the credit would be more generous than simply exempting the foreign income from U.S. taxation. Take a company with \$100 in U.S. taxable income and \$100 in foreign income. Suppose the foreign tax is \$60. If the foreign income is simply ignored, the company's U.S. tax bill will be \$46. Treating the entire \$200 as tentatively subject to a U.S. tax of \$92 but allowing a foreign tax credit of \$46 yields the same result. But allowing a foreign tax credit for the entire \$60 paid to the foreign government would cut the tax paid to the U.S. government to only \$32—a third less than if the foreign income were exempt from U.S. tax.

sons explained below, we believe that considerations of both tax policy and economic policy strongly indicate that the moratorium should not be extended. Instead, the 861-8(e) regulations should be put back into effect, preferably in strengthened form.

The basic issue with regard to the 861-8(e) regulations comes down to the following: Should companies that perform R&D in the United States for the purpose of supporting manufacturing abroad be allowed to use the foreign tax credit to reduce their federal taxes otherwise due on profits earned in the United States?

In light of the purpose of the foreign tax credit discussed above, from a pure tax policy viewpoint this question can have only one answer: No. It therefore necessarily follows that some rules for apportioning R&D costs between domestic and foreign income are required, unless considerations unrelated to tax policy strongly dictate a different approach.

One of the two arguments that have been put forward against the 861-8(e) regulations is that, even if some apportionment of R&D costs is appropriate, the rules as currently drafted arbitrarily apportion too high a share of R&D costs to foreign-source income. The second argument against the 861-8(e) regulations does not purport to be based on considerations of tax policy, but instead is made on economic grounds. That position is that any R&D-apportionment rules, no matter how technically correct, create a serious disincentive for American companies to perform R&D in the United States. We do not believe that either of these assertions can withstand analysis.

1. Over or under apportionment?

A quick walk through the mechanics of the 861-8(e) regulations illustrates that, far from apportioning too large a share of R&D expenses to foreign-source income, the regulations almost certainly apportion too little.

The 861-8(e) apportionment process begins by dividing R&D expenses into broad product categories. This first rough cut sensibly assures that, for example, a company that engages in R&D involving chemicals and non-electrical machinery, and manufacturers both in the United States but only chemicals abroad, will apportion only its chemical-related R&D costs between domestic and foreign income. Note that, even if the company sells its American-made machinery overseas, there will be no apportionment of machinery-related R&D to foreign profits. Distribution is in a separate broad product category. Note also that any R&D undertaken solely to meet U.S. legal requirements and which cannot reasonably be expected to generate foreign profits is allocated solely to U.S.-source income.

The next step begins with a decision that is a bit like the choice individual taxpayers face in deciding whether to itemize deductions on Schedule A of Form 1040. Companies are allowed either to take a "standard allocation" to U.S.-source income of 30 percent of their apportionable R&D costs or to allocate a larger amount solely to U.S.-source income if they can show that a higher percentage is appropriate. Here, if a company chooses to "itemize," it can break its product lines down very narrowly. For example, if a company makes lawnmowers in the U.S. and bulldozers abroad and 60-percent of its U.S. machinery-related R&D can be linked solely to lawnmowers, then 60 percent of the cost of that R&D will be exclusively allocated to U.S.-source income. As part of the "itemizing" process, a company can also increase its exclusive allocation of R&D costs to U.S.-source income by showing that there is a lag in applying R&D findings to foreign markets compared to their application to U.S. markets.⁴

Whatever is left after these calculations are completed is then apportioned between U.S.-source income and foreign-source income based on sales of relevant products within the broad product categories. For purposes of this sales-based apportionment, sales, sales by a controlled foreign subsidiary are taken into account only if the foreign company can reasonably be expected to benefit from the relevant R&D. This means that the U.S. parent can be expected to license, sell, or otherwise transfer the fruits of the research to the foreign subsidiary.

Once an apportionment based on sales is completed, there is one final step: Whatever amount has been tentatively apportioned to foreign-source income is simply cut in half.

⁴ The assumed discount rate for each year of delayed foreign application is 10 percent (although companies are free to try to show that a higher discount rate is more appropriate). Thus, if a company were to establish that foreign application of the relevant R&D lagged behind U.S. application by five years, 41 percent (1 minus 0.9 to the fifth power) of the R&D would be exclusively allocated to U.S.-source income.

Now, what's the bottom line on all this? Well, assuming that a company uses the 30-percent "standard allocation" to U.S.-source income, then the maximum apportionment to foreign-source income will be 35 percent times the share of total sales in a relevant product line represented by foreign sales. In other words, if U.S. and foreign sales are equal, R&D expenses will be apportioned 82.5 percent to U.S.-source income and 17.5 percent to foreign-source income. Or, if foreign sales represent all the sales in a relevant product category, 65 percent of the R&D expenses will still be apportioned to U.S.-source income and only 35 percent will be apportioned to foreign-source income.

And, remember, this is the maximum that must be apportioned for foreign-source income. In practice, many companies will be able to take advantage of the "itemized deduction" route to reduce their foreign apportionment quite substantially from the low amount prescribed by the general rules. And companies can avoid the application of the 861-8(e) regulations altogether by entering into arrangements under which foreign subsidiaries share in the costs of R&D on a reasonable basis.

How anyone can reasonably argue that these rules overapportion R&D to foreign-source income is difficult to fathom. In fact, we are convinced that a proper apportionment of R&D expenses requires a significantly higher apportionment to foreign-source income than the current 861-8(e) regulations mandate. Specifically, we recommend two steps:

First, the 30 percent "standard allocation" rule should be reexamined. In the interest of simplifying tax administration and compliance, some "standard allocation" to U.S.-source income may be appropriate, but on its face the 30 percent allowance seems too high.

Second, the completely arbitrary rule allowing companies simply to cut their foreign-source R&D apportionment in half after the other calculations have been completed should be dropped. The framers of this rule have all but admitted that it was adopted solely to reduce political pressure on the overall regulations. Since it has obviously failed to achieve that political purpose, it no longer has any rationale at all.

2. Incentives for what?

The suspension of the 861-8(e) regulations has cost the Treasury an estimated \$120-240 million a year. Almost all of that has been enjoyed by 24 Fortune-100 firms, apparently including ITT, United Technologies, TRW, and Eaton Corporation.

To qualify for the moratorium's tax forgiveness, these companies must first have more foreign tax credits than they can use. In addition, they must perform R&D in the United States to support foreign manufacturing operations.

What "incentive" is created by a tax break that goes to corporations that use U.S.-performed R&D to support foreign manufacturing? The companies affected argue, of course, that they have an incentive to do more of their R&D in the United States. More plausibly, however, it could be argued that the real incentive is for the companies to shift manufacturing jobs abroad.

The possibility of a firm shifting its R&D abroad simply because the U.S. government refuses to give it an additional tax break seems quite remote. In its June 1983 study on the impact of the 861-8(e) regulations on the location of R&D activities, the Treasury Department concluded that "it appears that foreign R&D is not highly substitutable for R&D performed in the United States." Treasury's finding was based on both theoretical analysis and on a number of careful studies and surveys of companies by other researchers, showing that the advantages of centralized R&D operations make setting up R&D facilities around the world costly and inefficient.

Treasury's finding is buttressed by the historical evidence. During the five years the 861-8(e) regulations were in effect, far from there being a trend toward R&D shifting abroad, exactly the opposite occurred. From 1977, the year the rules were adopted, to 1981, U.S.-performed, privately-financed R&D grew 50 percent faster than R&D undertaken by foreign affiliates of U.S. companies. The share of R&D performed by foreign affiliates fell 7.3 percent. If one allows that companies may have needed a few years to react to the issuance of the 1977 regulations, the data are even more striking. From 1979 to 1981, for example, U.S.-performed, privately-financed R&D grew by 15 percent in real terms, while R&D by foreign affiliates of U.S. firms fell by 4 percent in constant dollars. And the foreign share of total R&D dropped by 15 percent (to only 8.2 percent of the total).

If neither theory nor data suggests that there is any reason to fear that enforcement of the 861-8(e) regulations will stifle domestic R&D, the possibility that failure to enforce the rules will encourage, at least on the margin, a shift of manufacturing jobs abroad cannot be so easily dismissed. Given the current strength of the dollar,

there are substantial advantages to foreign production that Congress should be careful not to augment. And it certainly seems possible that a firm that is reluctant to set up a foreign manufacturing operation in a country with a high tax rate might be encouraged to make the move by U.S. tax rules that in effect put the U.S. government in the position of bearing some of the burden of those higher foreign taxes.

Thus, for economic as well as tax policy reasons, we recommend that the moratorium on enforcement of the 861-8(e) regulations be allowed to expire. And, as stated above, for the same reasons we urge the Treasury to amend the regulations so that they more accurately apportion R&D costs between domestic- and foreign-source income.

CONCLUSION

In designing the tax laws, Congress' primary concern ought to be to raise sufficient revenues to fund the government in a way that promotes economic fairness. In doing so, Congress should also be aware that provisions that undercut tax fairness and erode the revenue base often have unintended harmful economic impacts as well. These hearings have given the Subcommittee the opportunity to begin to explore some of the provisions of the tax code that not only violate sound tax policy but also appear to have counterproductive ramifications with regard to locational decisions by multinational corporations. We hope that the Subcommittee will continue to investigate this area and that its efforts will help produce fairer, economically more sound tax provisions governing U.S. taxation in the international area.

PRIVATE-INDUSTRY RESEARCH AND DEVELOPMENT PERFORMED IN THE UNITED STATES AND BY FOREIGN AFFILIATES OUTSIDE THE UNITED STATES

[A. Constant-dollar data and foreign share of total R&D]

	R&D by foreign affiliates of U.S. companies (millions of 1981 dollars)	R&D financed by private industry and performed in United States (millions of 1981 dollars)	Foreign share of total private R&D expenditures by foreign affiliates and their U.S. parent companies (percent)
1974.....	2,209	24,918	8.14
1975.....	2,260	24,218	8.53
1976.....	2,450	25,758	8.67
1977.....	2,620	26,998	8.85
1978.....	2,872	28,744	9.08
1979.....	3,294	30,756	9.68
1980.....	3,464	33,354	9.41
1981.....	3,157	35,362	8.20

[B. Trends: Percentage change from previous year]

	R&D by foreign affiliates of U.S. companies (constant dollars)	R&D financed by private industry and performed in United States (constant dollars)	Foreign share of total private R&D expenditures
1975.....	+2.3	-2.8	+4.8
1976.....	+8.5	+6.4	+1.6
1977.....	+6.9	+4.8	+2.1
1978.....	+9.6	+6.5	+2.6
1979.....	+14.7	+7.0	+6.6
1980.....	+5.2	+8.4	-2.8
1981.....	-8.9	+6.0	-12.9
Addendum:			
1977-81.....	+20.5	+31.0	-7.3
1978-81.....	+9.9	+23.0	-9.7
1979-81.....	-4.2	+15.0	-15.3

Sources: U.S. Treasury Department, "The Impact of the Section 861-8 Regulation on U.S. Research and Development" (June 1983), Table 1, page 25, which is based on data from the National Science Foundation. Inflation data (GNP deflator) are from the 1983 Economic Report of the President, Table B-3, page 165.

Mr. ANTHONY. Thank you, Mr. McIntyre.
Mr. McGarrah?

**STATEMENT OF ROBERT E. MCGARRAH, JR., DIRECTOR OF
PUBLIC POLICY, AMERICAN FEDERATION OF STATE, COUNTY
& MUNICIPAL EMPLOYEES, AFL-CIO**

Mr. MCGARRAH. Thank you, Mr. Chairman.

Our union, the American Federation of State, County and Municipal Employees, with over a million members throughout the country, has a long history of concern with tax policy issues because we know that taxes, particularly in recent years, have fallen much more heavily on working people and the poor. We are working very hard around the country, here in Washington as well, to curb what we consider this unfair tax burden.

This issue before the committee today relates to high tech firms moving their plants from the United States to countries in the Far East and elsewhere. Atari, Hewlett-Packard, Mattel, Apple Computer and so forth, involve plants leaving California, a State where we have a large and growing membership.

Our more than 50,000 members in Massachusetts also are very concerned about the runaway plant problem in the high tech area. And our people know all too well when manufacturing companies close up to move abroad, the State and local tax base also is severely eroded, unemployment and welfare, and additional costs to the public sector skyrocket.

These plant location decisions are normally attributable to many factors, but of course taxes do enter into the consideration. And the current law allows corporations to take advantage of these generous Federal tax write-offs and credits for R&D costs and then turn around and use them to facilitate foreign production in low-tax, low-wage countries, as these examples I have described. We think this is an intolerable situation and we urge you to take immediate steps to correct it.

For many years the AFL-CIO has recommended that the deferral privilege be eliminated and we are encouraged that this might happen. The repeal of foreign tax deferral would be the single most important step to curb tax subsidies for runaway foreign plants.

Short of ending deferral, Congress should at least crack down on some of the worst abuses involving high tech plants moving abroad. Current tax code section 367 is supposed to put some restrictions on the tax-free transfer of technology offshore, but in practice the rules usually either don't apply or work feebly at best.

What could help in the section 367 area are rules that require that, even if the results of R&D are transferred abroad, the U.S. Government will retain its claim to tax currently the profits the R&D generates. Since the Government typically pays for about half to three-quarters of the cost of that R&D, that seems only fair.

Another issue before the subcommittee involves whether we should continue to give 24 multinational corporations an extra \$120 to \$240 million a year in unwarranted foreign tax credits because they do research in the United States to support their for-

eign manufacturing operations. This moratorium is something that we think has resulted in definite harm, suspension of these regulations. We think that this has encouraged a shifting of production jobs abroad.

Frankly, Mr. Chairman, just to summarize, we think these examples of Atari, Apple, and the other more established high tech firms have shown that smaller companies, as they mature, may indeed want to get into the job exporting business, and, therefore, we need to end the foreign tax credit subsidy for runaway high tech plants now, before its impact becomes even more serious.

We strongly recommend the 861-8 regulations be allowed to go back into effect. In addition, we urge the Treasury to consider strengthening the regulations to apportion a higher share of R&D expenses to foreign sourcing, since even the Treasury's own report found that the current rules are far weaker than many experts believe appropriate.

A recent survey of the House Democrats by the Democratic study group found that by a 97 percent to 3-percent margin, those responding were against tax incentives for American companies to move abroad. That is not surprising of course, but it is reassuring. We hope these hearings will impress the Members of Congress that simply because corporate lobbies label a tax loophole an R&D incentive, that does not mean it is necessarily good for America.

Often these tax breaks turn out to be unfair giveaways that drain revenues while creating perverse incentives for harmful economic behavior, like exporting jobs, and by doing so they chip away further at our chances for long-term growth, prosperity and international competitiveness.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF ROBERT E. MCGARRAH, JR., DIRECTOR OF PUBLIC POLICY, THE AMERICAN FEDERATION OF STATE, COUNTY & MUNICIPAL EMPLOYEES, AFL-CIO

My name is Robert E. McGarrah, Jr., Director of Public Policy for the American Federation of State, County and Municipal Employees' (AFSCME). I am accompanied by Charles M. Loveless of AFSCME's Department of Legislation. We are here today on behalf of the more than one million public sector workers which AFSCME represents throughout the nation.

AFSCME has had a long history of concern and involvement in tax issues. As a union representing government workers, we are concerned that the burden of financing government services has fallen more heavily on working people during the past decade. AFSCME members know all too well that an unfair tax system undermines public support for adequate funding of public services.

The issue before the Subcommittee today relates to high-tech firms moving their plants from the United States to countries in the Far East and elsewhere, taking thousands of jobs with them in the process. Many of the more notable examples—Atari, Hewlett-Packard, Mattel, Apple Computer, and so forth—involve plants leaving California, a state in which we have a large and growing membership. Our 40,000 members in Massachusetts are also particularly concerned about the runaway plant problem in the high-tech area. Our members know that when manufacturing companies close up and move abroad, the state and local tax base is severely eroded as well.

Obviously, a company can have many reasons to consider moving its manufacturing operations offshore. There are also lots of reasons for staying in the United States. Our concern is that the tax code may tip the balance toward moving abroad in a significant number of cases. And, of course, even if a company would go abroad with or without a tax incentive, there's no reason for the U.S. Treasury to reward the company for doing so.

What current law essentially provides is that corporations can take advantage of generous federal tax write-offs and credits for research and development costs and then turn around and use that government-subsidized R&D to facilitate foreign production in low-tax, low-wage countries. Thus, the U.S. can end up incurring large revenue losses to help pay for private R&D, while failing to get the benefits of the jobs or the future tax revenues the R&D was supposed to produce.

We believe that this is an intolerable situation, and we urge Congress to take immediate steps to correct it. For many years, the AFL-CIO has recommended that the "deferral" privilege—under which companies can put off paying U.S. tax on their foreign profits almost indefinitely—should be repealed. We want to repeat that recommendation here today. Repeal of foreign tax deferral would be the single most significant step toward curbing tax subsidies for runaway foreign plants.

Short of ending deferral, Congress should at least crack down on some of the worst abuses involving high-tech plants moving abroad. Current tax code section 367 is supposed to put some restrictions on the tax-free transfer of technology offshore, but in practice the rules usually either don't apply or work feebly at best.

What could help in the section 367 area are rules that require that, even if the results of R&D are transferred abroad, the U.S. government will retain its claim to tax currently the profits the R&D generates. Since the government typically pays for about half to three-quarters of the cost of that R&D, that seems only fair. Moreover, it would help curb the incentives for offshore production by high-tech companies. Rules requiring that foreign subsidiaries pay an appropriate portion of their profits back to their parent company to reflect the income the parent's R&D generates would be a sensible first step in this area.

Another issue before the Subcommittee involves whether we should continue to give 24 multinational corporations an extra \$120-240 million a year in unwarranted foreign tax credits because they do research in the United States to support their foreign manufacturing operations. I'm referring here to the 1981-enacted moratorium on enforcement of the 861-8 regulations, which deal with the division of R&D expenses between domestic and foreign income for purposes of the foreign tax credit limitation.

For the past two years, companies have been allowed to pretend that all their U.S. performed R&D relate solely to income earned in the United States. This is clearly false in most cases. The result is that Uncle Sam has been letting the companies affected use foreign tax credits to reduce the taxes they would otherwise owe on profits earned here in the U.S. In other words, these companies have been better off than if the United States simply exempted their foreign income from taxation.

The supposed purpose of this tax break, it is claimed, is to stimulate R&D here at home. The real incentive, however, can be to shift production jobs abroad. By definition, the added tax credits are available only to companies with large foreign manufacturing operations.

The Treasury Department recently completed a study of the 861-8 issue and concluded that the extra tax credits provide minimal stimulus to American R&D. Treasury also found that the loophole is of virtually no value to "small, relatively young high-technology companies"—the firms Congress probably thought it was helping when it enacted the 861-8 moratorium. In fact, the 24 giant corporations that get almost all the benefits are actually less R&D-intensive than the average firms in their industries. The smaller firms don't believe because in most cases they haven't yet started to export jobs. We can see from the examples of Atari, Apple, and the other more established high-tech firms, however, that as the smaller companies mature they may indeed want to get into the job-exporting business. And, therefore, we need to end the foreign tax credit subsidy for runaway high-tech plants now, before its impact becomes even more serious.

We strongly recommend that the 861-8 regulations be allowed to go back into effect. In addition, we urge the Treasury to consider strengthening the regulations to apportion a higher share of R&D expenses to foreign source income, since even the Treasury's own report found that the current rules are far weaker than many experts believe appropriate.

CONCLUSION

A recent survey of House Democrats by the Democratic Study Group found that, by a 97 percent to 3 percent margin, those responding were against tax incentives for American companies to move abroad. That's not surprising, of course, but it's reassuring.

We hope these hearings will help impress on members of Congress that simply because corporate lobbyists label a tax loophole an "R&D incentive" does not mean

that it's necessarily good for America. Often these tax breaks turn out to be unfair giveaways that drain revenues while creating perverse incentives for harmful economic behavior, like exporting jobs. And, by doing so, they chip away further at our chances for long-term growth, prosperity, and international competitiveness.

ATTACHMENT "A"

[From the Washington Post, July 10, 1983]

IS HIGH TECH UNPATRIOTIC?

WE'RE GIVING TAX BREAKS SO ATARI CAN SHIP JOBS OVERSEAS

(By Gerald W. McEntee)¹

Public opinion poll (multiple choice): Do you think it makes sense for U.S. tax laws to encourage high-tech American firms to move their manufacturing plants abroad?

- (a) Yes.
- (b) No.
- (c) Hell, no!

Don't spend too long trying to choose between (b) and (c). The official correct answer—or at least the apparent consensus among elected officials in Washington—is (a).

To be sure, most of our representatives don't want to encourage a shift of manufacturing jobs overseas. Instead, they think they're promoting American research and technology.

So-called "Atari Democrats," along with most Republicans, are the leaders in inadvertently promoting answer (a), so it's appropriate that last spring's decision by Atari, Inc. to lay off 1,700 American workers and transfer its computer assembly operations to Hong Kong offers an apt illustration of the perverse impact of current tax rules.

Certainly the lure of cheap labor was a factor in Atari's going abroad. But the tax code clearly provided additional incentives.

U.S. companies can defer taxes on foreign profits while still taking advantage of generous tax breaks for the R&D investments which create that income.

Consider Atari, which invests lots of money researching and developing new products in this country. It is allowed tax deductions for those costs, and in some cases also gets a federal R&D tax credit. The deduction saves Atari about 50 cents in federal and state taxes for every dollar invested, and the credit can add another 25 cents in tax savings. This leaves Atari's out-of-pocket cost for a dollar's worth of R&D somewhere between 25 and 50 cents.

If Atari uses its know-how to manufacture products in California, the government will tax the profits. But it's still a sweet deal for Atari. The company keeps at least half the profits, while putting up as little as a quarter of the capital outlays.

By shifting its production offshore, however, Atari has found a way to do even better. The government will continue to pay for 50 to 75 percent of Atari's R&D, but now it will get no share of the profits the R&D generates. As long as Atari reinvests its earnings abroad, U.S. taxes are indefinitely deferred. And, since Atari has carefully chosen to put its runaway plants in low-tax or tax-haven countries like Hong Kong, Ireland, and Taiwan, it won't have to pay any significant foreign taxes either.

But, you may say, now that the Atari situation is a cause celebre, the administration and Congress will certainly figure out what's going on and crack down on tax subsidies for exporting jobs. Don't bet on it. Our lawmakers seem intent on making things worse.

Last month, the Treasury Department recommended giving a couple of hundred million dollars a year in extra foreign tax credits to multinational firms that—you guessed it—do research in the United States to support foreign manufacturing operations.

The purpose of this tax break, its numerous congressional supporters claim, is to stimulate R&D here at home. What they fail to consider, however, is that the real incentive can be to shift manufacturing jobs offshore. By definition, the added tax credits are available only to companies with large foreign operations.

The foreign tax credit bonus at issue would extend a "temporary" measure enacted in 1981 and scheduled to expire this year. Pushed by Atari Democrats and

¹ Gerald W. McEntee is president of the American Federation of State, County and Municipal Employees. He was assisted in the preparation of this article by Robert E. McGarrah Jr. of AFSCME.

ITT, this measure blocked the IRS for two years from enforcing its "Section 861" regulations—rules promulgated in 1977 to try to curb tax subsidies for foreign manufacturing.

The 1981 law required the Treasury to analyze the impact of suspending the 861 regulations and report its findings to Congress this year. In May, Treasury staff dutifully completed a draft study that found the loophole unjustified. But then politics intervened.

Under pressure from congressional Republicans and multinational companies, Treasury Secretary Donald Regan ordered a last minute reversal of the report's conclusion.

Among other things, Treasury's analysis shows that almost all the money from the tax subsidies goes to 24 giant corporations and that the extra tax credits provide minimal stimulus to American R&D.

Treasury also found that the loophole is of virtually no value to "small, relatively young high-technology companies." These firms don't benefit because they haven't yet started exporting jobs.

If we wanted to stop paying companies to ship jobs overseas, the best first step would be to repeal the rule allowing deferral of taxes on foreign profits, as suggested by Presidents Kennedy, Carter and the AFL-CIO. Short of that, we could at least stop Atari-USA from transferring its patent and know-how to Atari-Hong Kong tax-free. Current law is vaguely supposed to limit such tax-avoiding transfers, but in practice it rarely succeeds.

In addition, Congress should allow the IRS to enforce its suspended foreign tax credit regulations—preferably in strengthened form.

Preserving American jobs ought to be politically popular, but, unfortunately, subsidies for "high tech" are the current rage in Washington.

Mr. ANTHONY. I want to thank both members of the panel. I have a couple of questions I would like to ask.

Do either one of you have an argument with the fact that as a public policy in the United States we need to be encouraging as much R&D as possible?

Mr. McINTYRE. I think certainly R&D is a good thing. We certainly don't want to get in the way of it. And with regard to Government policies, especially in the basic research area, we need to do everything we can. I agree with that.

Mr. ANTHONY. Do you have any quarrel with the thesis that from basic or applied research, we can create jobs, maybe create new industries?

Mr. McINTYRE. Certainly that is the record, that when people develop new products, it is good for jobs. Of course there is a big question as to where the jobs are created. We'd like them to be here in the United States.

Mr. ANTHONY. So what you are really saying is that you don't want to use the tax code to accomplish either of the two above?

Mr. McINTYRE. Well, one could argue, and I think many people will in the upcoming weeks as we start hearing testimony, that the R&D tax credit has been hopelessly inefficient in encouraging what we would like to see. But putting that issue aside, we still have to face up to the fact that if we give companies incentives to do R&D and the jobs the R&D produces end up abroad because we pay companies to do that as well, that is not a tax policy that makes any sense.

Mr. ANTHONY. It bothers me not knowing the details of what is a fairly technical, complicated area. I took the DSG quiz, to give that group some indication of where the votes may be, and it was very easy for me to check yes on the question concerning the vote to change the laws against tax incentives for American companies to

move abroad. I mean in that broad context, I was surprised it wasn't 100 percent.

But when you start examining each one on a detail-by-detail basis, I think not only would my opinion change, but also the opinions of 97 percent of the people would start to change because you start involving a lot of different factors and redefining what the problem is. As it becomes clear, the answer to the question becomes cloudier.

It is a real concern of mine. Could you just summarize for me why the allocation of R&D to U.S. resources would serve as the incentive to ship manufacturing overseas, rather than stimulate R&D domestic activities?

Mr. MCINTYRE. Let me explain to you first of all that to take advantage of this moratorium on the 861-8 regulations—in other words, to be able to allocate all your R&D to the United States in a way that makes any difference—first of all you have to have very high foreign taxes, higher than the U.S. rate; second, you have to do R&D in the United States; and third, you have to have foreign production.

Without all three of those, the 861-8 issue is irrelevant. So when a company is taking advantage of the moratorium on the 861-8 regulations, they have a theoretical incentive, I think one could say, to do R&D in the United States. They also have a rather clear incentive to engage in foreign production.

Now, which incentive is more important? In other words, what are we likely to see more of if this moratorium prohibiting proper R&D allocation exists?

Well, most of the studies we have read, including the Treasury study, suggest that there is not very much substitutability between United States R&D and foreign R&D. Obviously, there can be for particular companies. But in general we don't find, looking at the evidence, that companies can very easily shift R&D from their centralized U.S. locations to foreign R&D facilities.

More over—

Mr. ANTHONY. Would you yield at that point for two other questions?

One, the panel right before you indicated that if a U.S. company had a foreign subsidiary, it would be easy to establish an R&D facility within that organization contrary to what you are saying. And also, earlier Mr. Chapoton indicated that their study showed there may be as much as \$40 million in loss of R&D under the provisions.

Mr. MCINTYRE. On the first question, on whether in fact a company can move R&D abroad, it would be shocking not to find individual cases where that could occur. On the other hand, surveys of companies as well as theoretical analyses and articles have all found that the advantages of centralizing R&D operations rather than spinning off part of the R&D tend to outweigh any modest tax advantages from doing the spin-off. And that is what Treasury found.

In terms of the estimate the Treasury experts made on how much R&D might be reduced in the United States if the 861-8 moratorium were to expire, they concluded that any possible reduction had almost nothing to do with companies moving R&D abroad.

They found that there might be some reduction in overall R&D, but a very modest amount, probably less than the revenue cost to the Federal Government from failing to enforce the 861-8 rules. You would be better off giving that money to the National Science Foundation.

To get back to your original question, if we look at the 5 years in which the 861-8 rules were in effect, we find that American R&D went up 50 percent faster than R&D by foreign subsidiaries of American companies.

So there is little reason to fear that enforcement of the 861-8 regulations will cause companies to shift any significant portion of their R&D operations abroad. On the other hand, it is reasonable to fear that a continued suspension of the 861-8 rules could induce companies, at least on the margin, to shift production jobs overseas.

Mr. Chairman, the jobs issue is much easier to understand in the Atari-goes-to-Hong-Kong situation, where they are moving abroad to a situation where they have little or no foreign taxes and we don't tax them either. But the issue is similar, albeit much smaller, in the case where a company is trying to decide whether it will go to a high-tax foreign country. Initially, it might have a disincentive. But if we agree through our tax laws to pay those extra foreign taxes, we have reduced that disincentive that some foreign country has created.

Mr. ANTHONY. After having just returned from Hong Kong, I can see why people would want to go there. It is the greatest thriving free and illegal free enterprise system you have ever seen. We will address some of those issues in later legislation.

Other members of the committee have any questions?

Any members of the staff have questions they would like to offer?

I am going to yield to Mr. Rangel.

Mr. RANGEL. We want to thank you for not only the contribution that you have made on this legislation, but certainly on other complex matters that come before the committee. We hope you will continue to cooperate with us in presenting views that may be contrary to what some of the proponents of this legislation would want.

This committee now will stand adjourned until a week from Thursday at 2 o'clock.

[Whereupon, at 1:40 p.m., the hearing was adjourned, to reconvene at 2 p.m., Thursday, November 3, 1983.]

RESEARCH AND EXPERIMENTAL SOURCE ALLOCATION RULES

THURSDAY, NOVEMBER 3, 1983

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met at 2:10 p.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

Chairman RANGEL. The Subcommittee on Oversight will continue the hearings that we had on October 26 on research and development source allocation rules. Today we will have two panels of witnesses.

I want to thank you for your patience in waiting for us to resume. Congressman Pease is joining the subcommittee. We welcome him here. I know that he has a statement to make. And also I welcome the subcommittee member, Mr. Pickle, for any statement he would like to make at this time.

Mr. PICKLE. I have no statement.

Chairman RANGEL. Mr. Pease.

STATEMENT OF HON. DON J. PEASE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. PEASE. Mr. Chairman, thank you very much for so generously allowing me this opportunity to participate in your hearing today on the issue of the allocation of research and development expenses to United States and foreign income.

Today's discussion and your examination of this subject at last week's hearing will serve as the foundation of the committee's decision whether to extend the 2-year rule contained in ERTA providing for the allocation of all research and development expenses for research activities conducted in the United States to U.S. source income.

My specific concern today is the possible conflict in our tax policy objectives that might occur if a permanent allocation rule were enacted while at the same time the Government continued to allow the transfer of intangible assets such as patents, know-how, and secret processes from a U.S. person to a foreign corporation, tax free. I am particularly interested in tax incentives which encourage multinationals to do U.S. R&D when they may use the results of that R&D abroad tax free. R&D produces intangible assets

which U.S. companies may transfer to foreign subsidiaries without incurring U.S. tax.

The foreign subsidiaries may generally use those intangibles created in the United States in active manufacturing in foreign markets without incurring U.S. tax. The principle of deferral generally prevents imposition of U.S. tax on the income of those foreign subsidiaries until they have paid dividends to the U.S. parent corporations.

With respect to continuing the present moratorium or creating a permanent rule on allocation, it is my understanding that corporations with excess foreign tax credits believe that extension of at least the status quo is essential to avoid creating a disincentive for U.S. companies to conduct R&D in the United States. I am not certain that I agree there is a direct correlation between the source allocation rules and U.S. jobs necessitating an extension of the ERDA rule.

But I would like to express my concern that the ability to transfer intangibles to a foreign subsidiary free of U.S. tax can be an incentive to foreign investment and can cause subsequent job loss in this country. In the near future I will be offering a revenue increase amendment package to H.R. 4170, the Tax Reform Act of 1983, when this bill comes to the floor. Part of the package would change current law so that any transfer of intangible property by a U.S. person to a foreign subsidiary would be taxable unless it were established that a reasonable royalty would be paid to the U.S. person with the transferred intangible U.S. property.

Mr. Chairman, your hearings on the allocation of R&D expenses present us with the opportunity to examine the related subject of the tax free transfer of intangibles. I question the policy of, on the one hand, continuing a tax incentive to encourage multinationals to do R&D in the United States when, on the other hand, they may transfer the fruits of the R&D without paying for them.

It would appear to me that if a foreign subsidiary of a U.S. corporation manufactures in a country whose effective tax rate is lower than the U.S. rate, it will have a tax competitive advantage over U.S. companies that operate solely in the United States. The U.S. corporation with valuable intangible assets arising out of U.S. R&D may have a tax incentive to locate its manufacturing plants in low tax foreign countries, rather than in the United States. This will depend on whether investment credit accelerated depreciation, and other tax preferences provided to U.S. manufacturers are as valuable as deferral.

In some cases the tax advantage from establishing a new manufacturing plant outside the United States in a low tax country may outweigh the economies of scale that arise from expanding an existing U.S. manufacturing plant.

Mr. Chairman, I appreciate your letting me join with the subcommittee today in an examination of this issue and hope that whatever direction you take, it will be consistent with removing incentives in our Tax Code to corporations to locate overseas. Again, I thank the chairman for his courtesy and generosity.

Chairman RANGEL. Thank you, Mr. Pease. If you can get some support with the members of the subcommittee, that option would be included in our recommendations.

The first panel will be Richard Kaplan, a professor from Boston College of Law, speaking for himself and also speaking for Professor Ault; Jon Bischel, professor of law, Syracuse University; and Stephen D. Desmond, a partner of Price Waterhouse.

Thank you very much. We have written statements from all of the witnesses. They will be entered into the record without objection, and you can proceed to highlight those statements.

STATEMENT OF PROF. RICHARD L. KAPLAN, UNIVERSITY OF ILLINOIS, AND ON BEHALF OF PROF. HUGH J. AULT, BOSTON COLLEGE LAW SCHOOL

Mr. KAPLAN. Thank you, Mr. Chairman. I will be brief, both because you already have our statement and because many of the concerns that I was going to express have already been articulated very well by Congressman Pease.

The idea of allocating research and development expenses to U.S. income exclusively should not be seen as an R&D incentive at all. It is exclusively restricted to those companies that are operating in high tax countries and which have excess tax credits. In other words, this is no incentive to R&D, but rather to bigness, as in fact the Treasury Department's report—that is the Treasury Department of the Reagan administration—shows that 85 percent of the benefits under this regulation go to 24 companies in of the Fortune 100.

This allocation rule has no benefit to any small company operating in some garage in Silicon Valley, coming up with new ideas. It has no benefit to middle-size companies doing R&D here but selling their products overseas, because those companies do not incur foreign income taxes. The only benefit that this allocation rule under ERTA can have is for those big companies that have not only foreign sales but also foreign operations and manufacturing. And even within this category of mature companies with foreign operations, only those companies that are operating in high tax countries, higher than U.S. taxes, would generate the excess tax credits that are affected by this rule.

So first and foremost, we must understand that this is not an incentive for R&D. In fact, this mechanism actually reduces the U.S. tax burden of those 24 major companies on their U.S. income. They are not saving foreign taxes. They are saving U.S. taxes. So that their U.S. income does not bear the same proportion of tax that some small entrepreneur in Massachusetts or California must bear. If anything, the ERTA rule creates a competitive disadvantage for the small corporation vis-a-vis the large multinational.

Furthermore, I would refer you to a recent report of the National Science Foundation entitled "An Assessment of Three R&D Tax Incentives Provided by the Economic Recovery Tax Act of 1981." In this 47-page report analyzing the effectiveness or ineffectiveness of the R&D tax incentives in ERTA, not one word is mentioned about this particular rule, because the National Science Foundation understands that this is not an R&D incentive at all. It is not merely inefficient, it is not an R&D incentive that even merits discussion.

Rather, this is simply a mechanism to reduce U.S. taxes on U.S. income. Every accounting treatise acknowledges that the proper

way to handle these expenses is to use the same principles that multinationals apply internally, for their own reports, not just to R&D but also to interest expenses, home office expenses, and other overhead costs—namely, allocate those expenses to the income affected, including foreign source income. When these companies have done so, then perhaps they will get a deduction against their foreign source income from to foreign countries.

I mention that point not because it has any particular relevance to what the United States should do. That is, we are not supposed to underwrite the rest of the world's tax systems, but there is a great deal of smoke being blown about to the effect that these countries will not allow R&D deductions for the beleaguered multinationals of the Fortune 100.

In point of fact, virtually every country that these companies would have operations in has a tax treaty with the United States. These treaties have two interesting provisions relevant here. One, a nondiscrimination clause that requires our treaty partner not to discriminate against U.S. companies vis-a-vis their local companies. That applies to all principles of treating taxable income and expense. More specific is a second provision that I have listed in exhibit A to our prepared statement. Under these provisions, our treaty partners acknowledge that general and administrative overhead-type expenses shall be allocated and allowed as deductions against foreign taxes. That is not to say that the companies have a blank check. No, each provision limits the allowable deductions to the amounts that are reasonably attributable.

So all the bellyaching that we are hearing is really an audit issue: that is, whether research and development expenses properly allocable to foreign source income are going to be allowed as deductions by the foreign countries. They have said in their treaties that if the expenses are reasonably attributable, they will be allowed. Of course, there may be questions about whether a particular R&D expense is reasonably attributable. But that is neither a treaty issue nor a tax policy issue. That is simply an administrative matter.

After all, our own Internal Revenue Service doesn't allow every deduction that one claims, unfortunately. The R&D issue is the same issue that applies, say to entertainment expenses of corporate lobbyists. Those expenses may be deductible, but their deductibility must be proven to the satisfaction of the taxing authorities. The same principle applies here to R&D.

The foreign taxing authorities may certainly question the specific amounts allocated to foreign source income. But the fundamental idea that some U.S. based R&D or other overhead expenses may be allocated to foreign source income is part of every U.S. tax treaty.

I will conclude with one final point, because there is so much wrangle, if you will pardon the pun, about jobs, and that this is really a jobs bill. Not being a Congressman, I can only imagine how tiring it must be for every single corporate tax deduction to be masqueraded as a jobs bill. Aren't you just a bit tired of hearing about still another jobs bill, after ERTA—perhaps more appropriately entitled the "Employment Reduction Tax Act of 1981"—with its accelerated cost recovery system that was supposed to be the panacea for corporate America?

An interesting side effect is that ERTA reduced U.S. effective corporate tax rates so that most of our trading partners now have higher tax rates than we do, often substantially so. As a consequence, multinationals are generating these excess foreign tax credits that they are now asking you to help them with. If we continue the unprincipled rule that ERTA created for R&D, we will not see more R&D, nor any new jobs. About the only jobs affected by this rule are those of the corporate lobbyists you have already heard from.

Thank you.

Mr. RANGEL. Thank you for your eloquent and searching remarks.

[The prepared statement follows:]

STATEMENT OF PROF. RICHARD L. KAPLAN, UNIVERSITY OF ILLINOIS, AND PROF. HUGH J. AULT, BOSTON COLLEGE LAW SCHOOL

Mr. Chairman, we are law professors who teach in the area of taxation with particular emphasis on the U.S. taxation of international transactions. Accordingly, we have followed the developments affecting Treasury Regulation § 1.861-8 for some time, especially the attention devoted recently to the question of allocating research and development (R&D) expenses between U.S. and foreign source income. It is our view that the moratorium on the application of the Regulation should not be extended. The suspension of the existing Regulation as it applies to R&D expenses was ill-advised and is impossible to justify. R&D expenses should be treated on the same principle as any other type of income-producing expense.

INTRODUCTION

In essence, the Regulation requires that R&D expenses be allocated between U.S. (domestic) and foreign source income on the basis of various factors, which ultimately try to match revenues earned with the expenses incurred in earning those revenues. Some of the details of the allocation formulae in the present regulation could certainly be questioned—indeed, in many situations they seem too generous to us—but the basic principle that these costs should be allocated is beyond dispute. The concept that expenses should be allocated to the various categories of revenue that those expenses helped produce is at the heart of financial accounting principles and, despite occasional departures, is embodied as a central feature in our federal tax system. That is the clear import of Internal Revenue Code section 861 and its implementing Regulations. If this principle is abandoned, income derived in part from certain expenditures would not be matched with those expenditures, resulting in inappropriate distortions.

That is why the section 861 Regulations apply to a wide variety of expenses, not just research and development costs. Interest expenses, home office management costs, legal and accounting fees, income taxes, and other expenditures are equally subject to the allocation regime currently under attack. The proper treatment of all of these costs is to allocate them between foreign and U.S. source income. That is the principle adopted for any expense that cannot be specifically associated with a particular source of income but which benefits the entire enterprise, or at least several parts of that enterprise. The Regulation, in other words, subjects R&D expenses to the same allocation rule that applies to other overhead-type costs, and any proposed departure from this principle should satisfy a rather heavy burden of proof.

R&D SUBSIDY

Since the proposal to allocate all R&D expenses to U.S. source income cannot be justified on the basis of general tax concepts and principles, proponents have sought to cast it as an R&D incentive. But this proposal would have little impact on research undertaken in this country. Its principal impact is not on R&D at all, but on the calculation of the foreign tax credit. For U.S. taxpayers, the allocation of expenses between foreign and domestic source income is part of the effort to limit the tax credit allowed by U.S. law for taxes paid to foreign governments on foreign source profits. Without this limitation, which has been part of the foreign tax credit mechanism from its beginnings, the United States would be allowing a credit against U.S. taxes owed on U.S. source income. This result comes about as follows. If

expenses are not allocated to foreign source income, then the limitation on the credit for foreign taxes is increased, since the limitation is then expressed in terms of gross income rather than net income—necessarily a larger number. In effect, the foreign taxes are being credited against the U.S. tax owed on U.S. source income. That has never been the policy of the U.S. taxing statutes, and there is no serious effort to change this long-standing policy—even now.

TAXPAYERS AFFECTED

The R&D allocation issue, for all of the rhetoric about encouraging R&D, has its impact only on the foreign tax credit limitation of companies that are operating in countries with effective tax rates higher than that of the United States. Only those corporations have "excess credits"—foreign taxes actually paid—that they presently cannot use because of the restriction that these credits be applied exclusively against U.S. taxes on foreign source income. These companies, accordingly, are the claimants now petitioning for relief from this fundamental limitation. In effect, they want to repeal the section 904 foreign tax credit limitation, at least as it applies to them. This proposal, in other words, is simply special interest legislation for a limited class of beneficiaries.

And who are these beneficiaries? According to the June 1983 Report on this subject prepared by the Reagan Treasury Department, 85 percent of the tax benefit from the proposed change would go to 24 companies on Fortune magazine's list of the 100 largest U.S. industrial corporations. (p. 32) It is this rather small group that has the wide-reaching foreign operations, including operations in relatively high-tax countries, that produce the "excess credits" situation that Code section 861 tries to monitor. Thus, the repeal of the R&D regulations presently sought would primarily benefit large, mature corporations, not the start-up, innovation-oriented, high technology concerns that have high R&D expenses, but little or no foreign source income. Quite to the contrary, the proposed change in allocation rules has virtually no significance to even midsize firms selling their products overseas, because foreign sales are not generally subject to the foreign taxes that the 861 Regulations affect. This change, in other words, is no subsidy to R&D, but rather is a subsidy to big companies—the biggest, in fact, of the big multinationals.

FOREIGN LAW ISSUES

A related issue is the contention that these multinational corporations need special treatment, because foreign governments will not allow them to deduct U.S.-based R&D costs against their foreign source earnings. If they could, of course, the whole issue would largely disappear since the high-rate foreign taxes presently producing the "excess credits" would be reduced pro tanto. Quite apart from the unstated premise that the United States should act as ultimate underwriter for the rest of the world's tax systems, the assertion that foreign deductions are being systematically disallowed is highly overstated, if not entirely fallacious. Regardless of whether the question arises between a U.S. head office and a foreign branch or between a U.S. parent and its foreign subsidiaries, some R&D expenses are properly allowable against foreign earnings, be the context one of licensing royalties, cost-sharing arrangements, or intercompany transfer prices. The foreign country, to be sure, may try to reduce the amount of such allowances, just as the U.S. Commissioner of Internal Revenue monitors claimed deductions and disallows those he finds questionable. Negotiations between the U.S. company and the foreign government on these issues may then take place—so-called "horse trading"—but that is fundamentally an audit issue, a question of verifiable costs and their proper treatment. The central idea that some related R&D expenses may be deducted against foreign earnings is widely recognized. Indeed, it is clarified in every income tax treaty that the United States presently has in force, as set forth in Exhibit A to this Statement. Thus, the specter of asymmetrical treatment of R&D costs by foreign nations is really not a serious argument. In principle, such deductions are allowed by our treaty partners, though of course there may be some dispute in individual cases about the amount of the deduction, as there is in intercompany transactions generally—whether domestic or foreign.

OTHER EFFECTS AND CONCLUSION

Finally, and this is by no means the least significant issue, repealing the R&D rules would seriously jeopardize the delicate compromise represented by the section 861-8 Regulations. These Regulations went through a particularly vexatious gestation period of some eleven years, during which time two earlier drafts were released

and extensively criticized. Only after extensive consultations with the affected industry groups was the final version of these rules released in 1977. The Regulations embody numerous compromises made by both sides to achieve a proper balance between fairness for taxpayers, on the one hand, and protection of the fisc, on the other. The general approach of these Regulations is really rather generous, but the point remains that these Regulations cover a wide range of affected transactions. The present controversy involves only one issue—R&D expenses. But make no mistake. If this handful of multinationals wins repeal of the R&D rules, other taxpayers will step forward and seek repeal of those aspects of the section 861 Regulations that pinch their activities. Overriding the Treasury Department's delicate compromise in the R&D area, in other words, will not put the issue of allocating expenses to rest. Very much to the contrary, it will encourage other groups to challenge other parts of this multi-faceted Regulation and to seek from Congress the sort of special interest legislation being sought here. The correct approach is to return to the principled treatment of the allocation of R&D expenses worked out in the 1977 Regulations.

EXHIBIT A

United States tax treaties with the following countries have provisions permitting allocation of U.S.-based costs to foreign source earnings (applicable provision shown):

Argentina 7.3	Korea 8(3)
Australia III(3)	Luxembourg III(3)
Austria III(3)	Malta 7(3)
Bangladesh 7.3	Morocco 7(3)
Belgium 7(3)	Netherlands III(3)
Canada III.1	Netherlands Antilles III(2)
Denmark III(3)	New Zealand III(5)
Egypt 8(3)	Norway 5(3)
Finland 8.3	Pakistan III(3)
France 6(3)	Philippines 8(4)
Germany III(3)	Poland 8(3)
Greece III(2)	Romania 7(3)
Hungary 7.3	South Africa VI (4); VII
Iceland 8(3)	Sweden II
Ireland III(3)	Switzerland III(4)
Israel 8(3)	Trinidad and Tobago 8(3)
Italy III(5)	U.S.S.R. IV(3)
Jamaica 7(3)	United Kingdom 7(3)
Japan 8(3)	

Chairman RANGEL. May we hear now from Professor Bischel.

STATEMENT OF JON BISCHEL, PROFESSOR OF LAW, SYRACUSE
UNIVERSITY COLLEGE OF LAW

Mr. BISCHEL. Thank you, Mr. Chairman.

My name is Jon Bischel, and as indicated in my written statement I hold an appointment at the Syracuse University College of Law. I have also taught at three other law schools, including two graduate tax programs in Boston and Florida. Most importantly, however, I spent 15 years writing in the area of technology taxation, including three books and approximately 20 articles. For that same 15-year period I have also maintained an extensive private practice, and I specialize in working with small high technology companies.

As indicated, in 1977, the U.S. Treasury finalized the expense allocation and apportionment regulations pursuant to section 861 of the code. In my opinion they constitute a major disincentive, not incentive, to research and development activities carried on in the United States. The thrust of the regulations is to arbitrarily allo-

cate current R&D expenditures for potential new products to current sales, both domestic and foreign. Such allocation and apportionment is made without any causal relationship between the R&D effort, whether successful or unsuccessful, and current sales by a taxpayer.

It perhaps might be interesting to do a little more wrangling here and go back away. The origin of these regulations actually goes back about 10 years. They were first proposed in 1973. At that time a number of tax practitioners took strong issue with the arbitrary aspects of the allocation of current R&D expenditures for potential new products to occur on sales of present products. We wrote to the Treasury. We indicated at that time that there were a number of concerns. First it was pointed out that there is actually no difference between research and development expenditures, and any other current deduction whose benefit might extend into the future.

For instance, there is no allocation of current U.S. advertising expenditures to foreign source income. Despite the fact that some types of current U.S. advertising may become useful abroad at some future date. Therefore, it seemed unfair to single out R&D expenditures and to arbitrarily discriminate against them. Like an advertising expense, the R&D deduction is essentially an incentive deduction under section 174 which allows the taxpayer to deduct what would otherwise have to be capitalized.

Indeed for the past 30 years Congress has created a strong record in favor of R&D incentives. The basic reason for that strong record is, of course, that R&D is most frequently a very, very high risk proposition. There are instances in which the probability of successful research and development in certain areas is less than one in a million.

Second, it was pointed out that in a number of important instances of definition and classification under the R&D regulations, the consequences simply don't make any sense. For example, the definition of R&D costs includes such expenditures for patent attorneys, for filing of U.S. patents, an expense that cannot conceivably be allocable to foreign source income. Also, the regulations use an arbitrary method of classifying product lines which I think is well familiar to this committee.

One example that creates a presumption, of course, that bulldozers and lawnmower engines are somehow related. Seems to me highly unlikely. Another big problem which was not dealt with at all is the matter of unsuccessful research and development expenditure. Apparently it is assumed that the regulations that unsuccessful R&D, which is usually a high proportion of the total R&D costs, applies equally to foreign as well as to U.S. sales.

In reality the fact is that generally R&D is done first for the domestic market and therefore would seem only appropriate to allocate unsuccessful R&D costs to the markets to which they were initially targeted. Successful R&D cost ought to be allocated on the basis of the relative value of the markets for which they are developed, and such allocations should actually be made only when sales in the respective markets actually take place.

And in support of that statement I would like to cite Mr. Chapman's testimony. I don't have his testimony before this subcommit-

tee, but I do before the Senate subcommittee. On page 3 of his prepared statement he indicates that on tax policy grounds, some allocation to foreign source income is appropriate when domestic R&D is exploited in the foreign market and generates foreign as well as domestic income.

Likewise, the allocation of interest on other expenses is compelled by the code, et cetera, when an expense item generates foreign source income. In basing allocation of R&D on current sales, the critical assumption is made that R&D will remain about the same percentage of sales over a span of years. In fact, the percentage of R&D in relation to sales can vary considerably from year to year. This erroneous premise can prove almost fatal to heavy R&D startup operations. In particular, the small high-technology companies which I believe are the backbone of America's competitive technological edge.

As a practical matter, small high tech companies get four to five times the return on their R&D dollars compared to larger companies. The Treasury has indicated that 85 percent of the tax reduction resulting from the suspension of the R&D allocation regulations goes to a comparatively few companies. However, it ignores a very critical factor. That is it doesn't estimate at all, doesn't make any attempt to estimate which companies will be hurt the most in R&D activities if the regulations are not suspended.

It would appear that a substantially greater disproportionate part of the disincentive resulting from the R&D allocation regulations falls squarely on small high tech companies which do not have the same luxury large companies have possessing the ability to spread the so-called R&D tax over a high volume of sales.

And I might point out as well as a practical matter, the study does not take into account, because it probably could not, the relative proportion of the total budget and the total of research and development cost in comparison to sales of large companies in contrast to the small high tech companies.

There is statistical evidence that suggests that proportion for the small companies is two to three times the amount for the larger companies. So if there is an effect, it is a very, very devastating effect to the smaller companies. As a final matter on this particular point I might indicate that recent Treasury statistics indicate that for the year I believe it is 1980, some 6,137 foreign tax credit forms for 1,118 corporations were filed.

If, in fact, we are talking about only 28 companies, my question is what about the other 6,100? The Treasury response to our initial objections to the 1973 regulations was that in October 1975 they asked their agents not to develop any issues on the R&D regulations because they felt there were substantial problems with them.

Finally, the 1977 regulations came out with an exclusive allocation formula, some delayed application, a Government exclusionary formula. But they never responded to the basic problem. And that was how to equitably allocate what is basically a tax incentive, if at all, on a fair basis instead of an artificial basis. The most interesting example I always like to draw, because this is a true example of a small high tech company which does its own research and development, does not export at all, and acquires a foreign corporation which does all of its own research and development as well.

There is no transfer of technology between the two entities. However, because of the somewhat similarity of products under the CIT code, whenever dividends are paid from the acquired foreign subsidiary R&D expense allocation of the U.S. R&D has to be made to those dividends. So due to the rather arbitrary irregularities and general reluctance of most industrialized countries, including the United States to permit a deduction of R&D expenses incurred abroad, the ultimate result of the R&D allocation regulations is a special R&D tax. And the R&D tax is essentially triggered by an artificial, partial reduction, or total elimination in the credit for foreign taxes which are paid by U.S. taxpayers engaged in R&D activities in the United States.

During the effective period of the regulations, some American businesses were as a result subjected to taxation on foreign source income at overall rates in excess of 100 percent. The response of the larger companies has been threefold. First, a few companies have formed a research and development holding company structure which tends to be operationally complicated and thus is not suited to most industry, in particular, small high tech industries.

Second, some companies have moved as much research as possible out of the United States. I think you have had other testimony to that effect. Thus, putting the United States in a position of having to make outbound royalty payments on technology which could instead have been an income source.

Finally, other corporations have simply terminated their internal research and development programs, relying instead on the direct or indirect purchase of new technology from smaller firms. In turn, smaller businesses have been discouraged from the prospect of exporting profitably and it is not true, I might add, that foreign firms do not bear any foreign taxes, or small firms. My experience with my clients in the small high tech firm area has been that they bear a very heavy tax burden abroad. It has been thoroughly confused by what appears to be mixed signals coming from Washington with respect to the importance of technology development.

In at least one case a smaller company with only about \$5 million in sales which has an interest in a foreign affiliate abroad is at this moment seriously considering selling this affiliate because of the fact that it has been put in a heavy excess foreign tax credit position, primarily because of the effects of the 861-8 R&D regulations when they were operative. This company is concerned that they may become operative again.

Mr. RANGEL. Professor, could you summarize your testimony because we do want to get another panel in this afternoon.

Mr. BISCHER. Thank you, Mr. Chairman.

To summarize, let me state that my experience with small high tech companies indicates that this regulation has produced a very negative psychological effect. Small high tech companies which are engaged in expanding foreign exports are especially concerned. The temporary suspension has proved, to say the least, confusing to some of the small high tech company managers in light of the R&D incentives they were supposed to have received under the 1981 act.

As a practical matter, the United States is not in a position where we can sell shoes to Italy or Korea, or steel to Japan. We really have two things to sell, natural resources, and I suppose we

could become a developing country again, or we can sell our high technology. Given the extreme importance of R&D and high technology to the United States and international trade, and economic world leadership, any artificial impediment to U.S. based R&D activities imposed by tax rules ought to be removed.

No other country, industrial, or developing, imposes burdens on domestic based R&D activities with tax rules such as the 861-8 regulations. Justification for the misallocation of R&D resources caused by the regulations has never been made. H.R. 1887 I believe should be strongly supported to permanently suspend the regulations and encourage U.S.-based international businesses to regain their competitive edge.

Thank you, Mr. Chairman.

Mr. RANGEL. Thank you, Professor.

[The prepared statement follows:]

STATEMENT OF JON E. BISCHEL, PROFESSOR OF LAW, SYRACUSE UNIVERSITY

Mr. Chairman and Members of this distinguished Committee:

My name is Jon E. Bischel; I presently hold an academic appointment as a Professor of Law at Syracuse University.

Mr. Chairman, I want to express my appreciation for the opportunity to testify before the Committee and present my views on important issues of tax revision.

The primary thrust of any continuing tax revision should center on incentives for capital formation, especially for the purpose of modernizing plant and equipment to make American business more efficient and competitive, both domestically and internationally. Thus, my statement will be confined to the area of improvement in the tax climate surrounding research and development embodied in H.R. 1887.

CONTINUED RESEARCH AND DEVELOPMENT MEASURES URGED

Mr. Chairman, the ability of American industry to create the needed capital and meet the economic challenges of the future is surely one of the most important questions facing the country today. Efficient production of more goods and services is essential to achieve any increase in the standard of living and this requires investment in research and development. In turn, successful research and development activity is a prerequisite for growth and profitability.

Yet, the preeminence of the United States in research and development activities has seriously eroded during the past decade. For instance, ten percent of every sale in Japan is poured back into research and development activity. The United States lags far behind with an average of two to three percent. In fact, the only United States industry which does put ten percent of sales back into research is the computer industry. However, even here the Japanese are out-spending the United States almost two to one and within two to three years will be challenging American industry for supremacy in this field, especially in the new fast-growing area of miniature computers.

An even more stunning statistic is the fact in the past few years almost half of all important patent applications received by the United States Patent Office have been filed by foreigners. Clearly, the United States has been placed in an imminent crisis position of losing its prime and, perhaps, only advantage in world trade, technological superiority.

Moreover, the resulting inefficiency in the domestic economy has been a prime cause in fueling the fires of inflation. From a tax posture, allocation of R & D costs must bear major responsibility for the recent United States R & D posture.

SECTION 1.861-8 R & D ALLOCATION REGULATIONS: BACKGROUND

In 1977 the United States Treasury finalized expense allocation and apportionment regulations pursuant to section 861 of the Internal Revenue Code which constitute a major disincentive to research and development (R & D) activities carried on in the United States. The thrust of the regulations is to arbitrarily allocate current R & D expenditures for potential new products to current sales, both domestic and foreign. Such allocation and apportionment is made without any casual rela-

tionship between the R & D effort, whether successful or unsuccessful, and current sales of a product by a taxpayer.

The origin of the R & D allocation and apportionment regulations actually stretches back about 10 years. The regulations were first proposed in 1973. At that time a number of tax practitioners took very strong issue with the arbitrary aspects of allocation of current R & D expenditures for potential new products to current sales of present products. We wrote to the Treasury and indicated a number of concerns.

First, it was pointed out that there is actually no difference between R & D and any other current deduction whose benefit might extend into the future. For instance, there is no allocation of current United States advertising expenditures to foreign source income, despite the fact that some types of current United States advertising may become useful abroad at some future date. Therefore, it seemed unfair to single out R & D expenditures and arbitrarily discriminate against them. Like the advertising expense, the R & D deduction is essentially an incentive deduction which allows a taxpayer to deduct what would otherwise have to be capitalized. Indeed, for the past 30 years Congress has created a strong record in favor of R & D incentives. The basic reason for such incentives is, of course, that R & D is most frequently a very, very high-risk proposition. There are instances in which the probability of successful R & D in certain areas is less than one in a million.

Second, it was pointed out that in a number of important instances of definition and classification under the R & D regulations the consequences simply did not make any sense. For example, the definition of R & D costs includes such expenditures for patent attorneys fees for the filing of United States patents, an expense which cannot conceivably be allocable to foreign source income. Also, the regulations use an arbitrary method of classifying product lines which in one example results in the presumption that bulldozer R & D benefits lawn mower engines, a highly unlikely connection.

Another big problem not dealt with at all is unsuccessful R & D. Apparently, it is assumed in the regulations that unsuccessful R & D, which is usually a high proportion of the total R & D cost, applies equally to foreign as well as to United States sales. In reality the fact is that generally R & D is done first for the domestic market. Therefore, it seems only appropriate to allocate unsuccessful R & D costs to the markets to which they pertain. Successful R & D costs ought to be allocated on the basis of the relative value of the markets for which they are developed and such allocations should actually be made only when sales in the respective markets actually take place.

In basing allocation of R & D to current sales, a critical assumption is made that R & D will remain about the same percentage of sales over a span of years. In fact, the percentage of R & D in relation to sales can vary considerably from one year to another. This erroneous premise can prove almost fatal to heavy R & D start-up operations, in particular small high-tech companies which are, I believe, the backbone of America's competitive technological edge. As a practical matter small high-tech companies get four to five times the return on R & D dollars compared to larger companies. The Treasury has indicated that 85 percent of the tax reduction resulting from suspension of the R & D allocation regulations goes to a relatively few companies. A critical factor ignored in the Treasury study is an estimate of which companies will be hurt the most in R & D activities if the regulations are not permanently suspended. It would appear that a substantially greater disproportionate part of the disincentive resulting from the R & D allocation regulations falls squarely on small high-tech companies which do not have the luxury large companies possess of spreading the cost of the R & D tax over a high volume of sales.

The Treasury response to all of this in the 1973 regulations was that in October, 1975 they asked their agents not to develop any issues on the R & D regulations because they felt there were substantial problems with them.

The 1977 regulations came out with an exclusive allocation formula, some delayed application, a government exclusionary formula; but they never responded to the basic problem—how to allocate what is basically a tax incentive, if at all, on a fair basis instead of an artificial basis.

THE R&D REGULATION CONSEQUENCES

Due to the arbitrary peculiarities in the structure of the regulations and the general reluctance of most industrialized countries (including the United States) to permit deduction of R & D expenses incurred abroad, the ultimate result of the R & D allocation regulations is a special United States "R & D tax." The R & D

tax is essentially triggered by an artificial partial reduction or total elimination in the credit for foreign taxes paid by United States taxpayers engaged in R & D activities in the United States. During the effective period of the regulations, some American businesses were, as a result, subjected to taxation on foreign source income at overall rates in excess of 100 percent.

The response of larger corporations has been three fold: (a) A few corporations have formed a research and development holding company structure which tends to be operationally complicated and thus not suited to most industry; (b) Some companies have moved as much research as possible out of the United States, thus putting the U.S. in a position of having to make outbound royalty payments on technology which could instead have been an income source; (c) Other corporations have simply terminated their internal research and development programs, relying instead on the direct or indirect purchase of new technology from smaller firms. In turn, smaller businesses have been discouraged from the prospect of exporting profitably and thoroughly confused by what appears to be mixed signals coming from Washington with respect to the importance of technology development.

In at least one case a smaller company with only about \$5 million in sales, which has an interest in a foreign affiliate abroad, is seriously considering selling this affiliate because of the fact that it has been put in a heavy excess foreign tax credit position primarily because of the effects of 861.8 with respect to R & D.

There is another situation which came to my attention recently of a small high-tech company in Western Massachusetts which has been placed in a position because of the R & D regs of incurring an extremely heavy tax burden with respect to exporting to another country. We suggested instead to them that they set up operations in Canada, and that we reorganize the company, and we can do this via some limited partnership arrangements. Thus, it is possible to avoid the effects of 861.8 in the R & D area for small high-tech companies. But the fact of the matter is that generally speaking it will mean exporting jobs. In this case it will mean they have to export 200 jobs to Canada.

In reality the R & D allocations apply to sort of formula ratio apportionment in many instances, where the United States in almost every other area has preferred apportionment using factual standards. The recent reactions to state formula apportionment pale in significance when compared with Federal formula apportionment that can produce effective income tax rates in excess of 100 percent.

The reason Treasury used formula apportionment in the R & D expense area is that they apparently could not devise a realistic factual standards structure. In the past 10 years the R & D allocation regulation has not worked. Instead, the result has been arbitrary apportionment and an administrative nightmare for both the Government and taxpayers. Convincing and overwhelming evidence exists which suggests that the R & D allocations frustrate the intent of Congress regarding proper treatment of R & D costs. The regulations yield only a minimal amount of revenue and suffer from serious flaws in both concept and administration. Small, high technology companies, the most productive factor in the American economy are particularly hard pressed in complying with an extraordinarily complex regulation for which they cannot afford expensive outside assistance to interpret. Additionally, the regulations are non-neutral in their economic impact taxing United States based R & D intensive international businesses at a higher effective rate than other taxpayers, thereby discouraging United States based R & D activity and adversely affecting the United States balance of payments.

My experience with small high-tech companies indicates that this regulation has produced a very negative psychological effect. Small high-tech companies engaged in expanding foreign exports are especially concerned. The temporary suspension has proved, to say the least, confusing to small high-tech corporate managers in light of the R & D "incentives" they were supposed to have received in the 1981 ERTA.

As a practical matter, the United States is not in a position where we can sell shoes to Italy or Korea, or steel to Japan. We have two things to sell: First, natural resources, as developing countries have to sell—and we can go back to the status of being a developing country; or, second, we can sell our high technology.

Given the extreme importance of R & D and high technology to the United States in international trade and economic world leadership, any artificial impediment to United States based R & D activities imposed by tax rules ought to be removed. No other country, industrial or developing, imposes burdens on domestic based R & D with tax rules such as the Section 1.861-8 regulations. The justification for the misallocation of R & D resources caused by the regulations has never been made. H.R. 1887 should be strongly supported to permanently suspend the Section 1.861-8 R & D regulations and encourage United States based international businesses to regain their competitive edge.

Chairman RANGEL. Mr. Desmond.

**STATEMENT OF STEPHEN D. DESMOND, PARTNER, PRICE
WATERHOUSE**

Mr. DESMOND. Mr. Chairman, I am Stephen Desmond. I appreciate your allowing me to appear before you today as a representative of my firm to make comments on the experimental resource allocation rules. My testimony will be brief in light of the fact that you have written testimony and the people on the joint committee are familiar with the issues I will raise at this time.

Price Waterhouse strongly feels that as a matter of national policy U.S.-based research activities must be encouraged, and for that reason we support the thrust of legislation to do so. In our view, the section 861-8 regulations may encourage the export of U.S. jobs and technology. Accordingly, Price Waterhouse feels that continuing and encouraging U.S.-based research outweighs any tax policy implications raised by the suspension of the section 861-8 regulations. Therefore, we oppose the lapse of the suspension period.

In June of 1983, I testified on behalf of Price Waterhouse on S. 654, relating to sections 861-2 allocation of research and experimentation expenditures to U.S.-source income before the Senate Finance Subcommittee on Taxation. During that testimony, we raised two technical points relating to the language and scope of the proposed legislation. Price Waterhouse has examined H.R. 1887 and would like to raise similar technical issues with respect to this proposed legislation.

First, based on the stated intent of the proposed legislation—that is, encouragement of U.S. R&D via elimination of disincentives imposed by the 861-8 regulations—it would appear that U.S.-incurred R&D should not be offset against the foreign element of income derived from partly within and partly without the United States—section 863(b)—and therefore subsection (g) should make specific reference to section 863(b).

To leave no doubt in the minds of those who have to implement the tax law, it was the intent of this provision to totally eliminate the negatives of foreign R&D against the foreign source income and foreign tax credit limitation.

The second point is clarification is needed as to the applicability of H.R. 1887 to provisions of the Internal Revenue Code other than those dealing with geographic sourcing, being foreign tax credit limitation only. If the intent of H.R. 1887 is to abolish the R&D provisions of the 861-8 regulations in their entirety, then all operative sections of the Internal Revenue Code should be included in the statutory language.

We at Price Waterhouse have assisted hundreds of multinational companies in implementing the 861-8 regulations and have an appreciation for the complexity of those regulations in general and the R&D provisions of those regulations in particular. So we have a significant interest to see that if changes are made to the 861-8 regulations, that both the scope and nature of those changes are thought out, if possible, in the legislative drafting process so that

the multinational companies will have guidance on how to implement that law.

Mr. RANGEL. Thank you.

[The prepared statement follows:]

STATEMENT OF STEPHEN D. DESMOND ON BEHALF OF PRICE WATERHOUSE

SUMMARY OF MAJOR POINTS OF WRITTEN TESTIMONY

Price Waterhouse strongly feels that as a matter of national policy U.S.-based research activities must be encouraged, and for that reason we support the thrust of legislation to do so. In our view, the Section 861-8 regulations may encourage the export of U.S. jobs and technology. Accordingly, Price Waterhouse feels that continuing and encouraging U.S.-based research outweighs any tax policy implications raised by the suspension of the Section 861-8 regulations. Therefore, we oppose the lapse of the suspension period.

In June of 1983, I testified on behalf of Price Waterhouse on S. 654, relating to Sections 861-862 Allocation of Research and Experimentation Expenditures to U.S.-source income before the Senate Finance Subcommittee on Taxation. During that testimony, we raised two technical points relating to the language and scope of the proposed legislation. Price Waterhouse has examined H.R. 1887 and would like to raise similar technical issues with respect to this proposed legislation.

Based on the stated intent of the proposed legislation (i.e., encouragement of U.S. R&D via elimination of disincentives imposed by the 861-8 regulations) it would appear that U.S.-incurred R&D should not be offset against the foreign element of income derived from partly within and partly without the United States (Section 863(b)), and therefore subsection (g) should make specific reference to Section 863(b).

Clarification is needed as to the applicability of H.R. 1887 to provisions of the Internal Revenue Code other than those dealing with geographic sourcing (i.e., principally pricing for Domestic International Sales Corporations). If the intent of H.R. 1887 is to abolish the R&D provisions of the 861-8 regulations in their entirety then all operative sections of the Internal Revenue Code should be included in the statutory language.

STATEMENT

Mr. Chairman, I am Stephen D. Desmond, a Price Waterhouse tax partner based in Chicago. I appreciate your allowing me to appear before you today as a representative of my firm to present comments on research and experimental source allocation rules.

In 1977, the Treasury Department issued regulations which provide that research and development expenditures must be allocated to foreign-source and U.S.-source income based on a broad classification of 32 product groups. Under the regulations, research expenditures are not allocable solely to the income generated by the particular product which benefitted from the research activity, but to all the income within the product group in which the product is classified. Therefore, once a research expenditure is identified with a product group, it is apportioned to foreign sources based on the ratio of total foreign source sales receipts or income within the product group to the total worldwide sales receipts or income within the product group.

Critics of the regulations noted that some foreign countries do not allow deductions under their tax laws for expenses of research activities conducted in the United States. Because corporations operating in certain countries could not deduct those expenses, they experienced unduly high foreign taxes.

Those corporations found they could take the deduction if the research occurs in those foreign countries, however, and therefore taxpayers were encouraged to shift their research expenditures to those foreign countries whose laws disallow tax deductions for research activities conducted in the United States but allow tax deductions for research expenditures incurred locally. In this way, they could obtain the full foreign tax credit on the income earned in that country.

Congress in the Economic Recovery Tax Act of 1981 (ERTA) temporarily suspended the Treasury's allocation rules on research expenditures. Therefore, ERTA provided that research and experimentation expenditures for activities conducted in the United States are to be allocated or apportioned to sources within the United States for the two taxable years beginning after enactment (August 13, 1981).

ERTA also directed the Treasury Department to study the impact of the research expenditure allocation rules on research conducted in the United States and the

impact on the availability of the foreign tax credit, and to forward the study, with recommendations, to Congress. Treasury released their study in June 1983 and recommended a two-year extension of the present moratorium.

Price Waterhouse strongly feels that as a matter of national policy, U.S.-based research activities must be encouraged, and for that reason we support the thrust of legislation designed to do so. In our view, the Section 861-8 regulations may encourage the export of U.S. jobs and technology. Accordingly, Price Waterhouse feels that continuing and encouraging U.S.-based research outweighs the tax policy implications raised by the suspension of the Section 861-8 regulations in determining whether the ERTA change should be made permanent or simply extended for an additional period of time.

In June of 1983, I testified on behalf of Price Waterhouse on S. 654 relating to Sections 861-862 Allocation of Research and Experimentation Expenditures to U.S.-source income before the Senate Finance Subcommittee on Taxation. During that testimony, we raised two technical points relating to the language and scope of the proposed legislation. Price Waterhouse has examined H.R. 1887 and would like to raise similar technical issues with respect to this proposed legislation.

The final regulations under Section 861(b) prescribe methodology for allocating and apportioning the expenses and deductions reported in a U.S. tax return against gross income from various sources to arrive at taxable income attributable to those sources.

While these regulations affect several operative sections of the Internal Revenue Code, their most widespread effect has been on the calculation of foreign tax credits and DISC pricing.

Specifically, the expenses, losses, and deductions of a taxpayer, when allocated and apportioned to foreign source gross income, determine the foreign source taxable income used as the numerator of the fraction that is applied to the U.S. tax liability to calculate the foreign tax credit limitation.

With respect to DISC pricing, the regulations provide that expenses are to be allocated and apportioned against profits on DISC sales using the methodology of Regulation 1.861-8 to determine combined taxable income of the DISC and its related supplier. Further, the Regulation 1.861-8 allocation and apportionment methods used for DISC pricing must be the same as those used in computing foreign source taxable income for purposes of the numerator of the foreign tax credit limitation calculation.

Price Waterhouse has assisted hundreds of multinational corporations in performing the calculations mandated by the Section 861-8 regulations. In so doing, we have developed an appreciation for the complexities of the regulations in general and the R&D provisions of these regulations in particular. These inherent complexities have imposed significant compliance and recordkeeping burdens upon the multinational business community.

One area of continuing confusion has to do with the use of the terms "statutory grouping" and "residual grouping." Depending on the specific calculation under the Internal Revenue Code (i.e., operative section) that the taxpayer is performing, the items of gross income and taxable income falling into each group will change. When the overall limitation to the foreign tax credit is under consideration, the statutory grouping is comprised of foreign source income subject to that limitation. With respect to the determination of income that is derived partly from within and partly from without the United States (Section 863(b)), the statutory grouping is comprised of transactions covered by that Code section. Transactions covered by Section 863(b) involve the rendering of services partly within and partly without the United States, and, more importantly for our discussions today, the sale of personal property manufactured in the U.S. and sold (title passed) outside of the U.S. (or vice-versa) and the sale in the U.S. of goods purchased in a U.S. possession.

When the combined taxable income of a DISC and its related supplier is under consideration, the statutory grouping is transactions qualifying for DISC treatment. These transactions generally are export sales. Of course, the sum of the statutory grouping and residual grouping, no matter how defined, will always be the total gross and taxable income of the taxpayer.

The regulations call for the same income and expense items (and the same detailed computations) to be done over and over as the taxpayer moves from one operative section to another. Moreover, the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections. That is, there must be consistency between each of the calculations. For example, assume that a multinational corporation manufactures two products—A and B—and exports such products in transactions qualifying for DISC treatment. With respect to product A, title passes inside the U.S. on sales of such product. With respect to

product B, title passes outside the U.S. on sales of such product. In this case, which I might add is very common, the taxpayer is required to allocate and apportion R&D expense three times using a consistent method: first, to determine combined taxable income for DISC pricing purposes (Product A & B); second, to determine Section 863(b) taxable income (Product B); and, finally, to determine foreign source taxable income for purposes of determining his foreign tax credit limitation (Product A & B).

The "one operative section at a time" approach is very cumbersome and, in most cases, unnecessarily compounds the work. Furthermore, it increases the probability that the sum of the parts will not equal the whole when all pertinent calculations are completed or that the consistency requirement will be violated.

If carefully approached, it is possible to overcome these problems by doing the calculations under all applicable operative sections simultaneously. In fact, it has been our experience that a simultaneous calculation is the only means to guarantee that more than 100 percent of the expenses will not be charged against the various components of income.

The provisions of H.R. 1887, however, appear to preclude the heretofore successful approach of performing required calculations under all operative sections simultaneously and consistently, as well as to require differing approaches to the allocation and apportionment of R&D depending upon which operative section calculation is being performed. I would like to bring the specifics of this problem to your attention with the hope that it can be addressed during the legislative drafting process.

H.R. 1887 provides that for purposes of determining taxable income from sources within the United States, all qualified research and experimental expenditures shall be allocated or apportioned to sources within the United States. The proposed provision would amend Section 861 of the Internal Revenue Code of 1954 by adding a new subsection.

The bill makes no reference, however, to Section 863(b), relating to income derived partly from within and partly from without the United States.

The absence of any specific reference to Section 863(b) in proposed subsection (g) of Section 861 would lead one to conclude that R&D expense can still find its way against foreign source income on transactions covered by Section 863(b). Given the significance of transactions covered by Section 863(b), we strongly encourage clarity in the proposed legislation. Based on the stated intent of the proposed legislation (i.e., encouragement of U.S. R&D via elimination of disincentives imposed by the 861-8 regulations), it would appear that U.S.-incurred R&D should not be offset against the foreign element of Section 863(b) income and, therefore, subsection (g) should make specific reference to Section 863(b).

With respect to DISC pricing, the question is whether H.R. 1887 is designed to deal only with operative sections of the code which require geographic sourcing of income (i.e., foreign tax credit limitation calculations) or to abolish the R&D provisions of Regulation 1.861-8 in their entirety (the latter would accomplish a degree of simplification). If the former is the objective, it would appear that the taxpayer in my earlier example would first perform DISC pricing calculations and, in so doing, allocate and apportion R&D expenses via the methodology of the 1977 regulations. The fact that Product A constituted U.S.-source income and Product B both U.S. and foreign source income via the provisions of Section 863(b) should have no bearing on the calculation of combined taxable income.

Then, assuming Section 863(b) is included in the section covered by the proposed subsection (g) of Section 861, the taxpayer would determine section 863(b) income and foreign source taxable income and in so doing, no U.S.-incurred R&D would go against the foreign element of Section 863(b) taxable income and/or other foreign-source taxable income.

From a technical standpoint, resolution of the technical issues we have raised is critical to the planning, compliance, and recordkeeping processes carried out by multinational corporate tax departments.

Thank you for providing Price Waterhouse an opportunity to testify on this subject. I would be happy to answer any questions the members might have.

Chairman RANGEL. Mr. Pickle?

Mr. PICKLE. Mr. Chairman, I have no questions.

Chairman RANGEL. Mr. Pease?

Mr. PEASE. Mr. Chairman, I would like to ask a question of Mr. Bischel.

In your statement you argue that the Treasury regulation is arbitrary and allocates apportionment without causal relationships.

If the Congress decides to continue to require some allocation between income sources, what specific allocation rule or changes to the Treasury regulation would you suggest?

Mr. BISCHEL. Mr. Pease, I believe that as I stated somewhat in my written statement, that the relationship ought to be on a factual basis instead of on a more or less formula basis which occurs now. That is the same basis that almost all of the Treasury regulations are written under. It is the one that the Treasury has favored for some past 30 years.

I would suggest one might begin targeting, taking a look at what purpose it is targeted, the markets. If R&D is targeted at both U.S. and foreign markets, an appropriate allocation ought to be made on the basis of the value of each of those markets. If in fact the R&D is unsuccessful, then it ought to be allocated immediately.

If it is successful, then there ought to be an allocation when in fact those, the products which are developed as a result of that research and development, are actually sold. As one who is interested in small high tech companies and the real burdens that they bear in terms of research and development, it would seem to me not inappropriate or inequitable to perhaps have a phase in of, say, possibly an exclusion from allocation on the first \$25 million of R&D, and perhaps a 50-percent inclusion for allocation purposes on the next \$25 million of R&D. That would effectively exclude many of the smaller high tech companies which are interested in exporting and being productive as far as the American economy is concerned.

It would exclude them from the difficulty of having to try and deal with these regulations which for them is an administrative nightmare. They have no ability to solicit qualified tax counsel to interpret these regulations.

Mr. PEASE. Thank you. You mentioned the excess tax credit position of several high technology firms. The subcommittee apparently continues to receive reports about how the small high technology firms are affected by the source allocation rules. Yet, the subcommittee has not received much testimony from small firms.

Further, small technical firms from our understanding are very interested in and benefit greatly from the 25-percent R&D tax credit. Will you comment on that?

Mr. BISCHEL. Are you asking me to comment?

Mr. PEASE. Yes.

Mr. BISCHEL. The answer is yes they do, or have I should say in the first year or two benefited significantly from the 25-percent R&D credit. On the other hand, as the base period begins to work itself up, the incentive from that credit is clearly not going to be as great. In addition, the small high tech companies that you are talking about, which do a substantial amount of exporting, are put in kind of a balancing act sort of position because of, although the 861-8 rates are suspended at the present time, if they come back onstream it will be more or less of a balancing act as to whether or not to do a substantial amount of R&D, picks up some additional credit, and then lose it on the other side by virtue of excess foreign tax credit liabilities.

So what it really does for the small high tech companies, especially from the tax manager's stance of looking at these, at the

effect of the R&D allocation regulations, is it makes the 44(f) credit in many instances nothing more than a wash.

Mr. PEASE. Again referring to the excess tax credit position of high technology firms that you mentioned in your testimony, why are these firms in an excess credit position?

Mr. BISCHEL. Well, what many of them have done is, has gotten into exporting either through a disk or whatever it might happen to be over a period of time. Of course the allocation regulations are applicable there as well. It is not true that one does not have any foreign tax liability. If you have a substantial exporting position and a permanent establishment in another country, whether you are manufacturing there or not, one may be manufacturing, what is not infrequent with small high tech companies, is they may make the higher tech components in the United States, export them to a foreign country, and have them assembled there.

So they do incur domestic tax liability, in particular in the Latin American countries it can be very heavy. That is why because of the—what is an inter-effect of the corporate tax and dividend withholding taxes in those countries. So in order to repatriate, frequently the effective tax rate can exceed 60 to 70 percent.

Mr. PEASE. I see. Thank you.

Chairman RANGEL. Professor Kaplan, would you care to ask your colleagues a question on this subject?

Mr. KAPLAN. Not so much that, Mr. Chairman, but I did want to address the issue that these regulations are so complex. That is an issue we hear a great deal about today—whether the Government is overburdening the corporate sector with complexity.

I think we need to keep some sort of perspective here. Remember that we are dealing with 24 of the Fortune 100. If they can't handle complexity, I'm not sure who can. But more importantly, we sometimes have this image of a nation of bookkeepers being summoned up to handle this regulation. That is really not the case here.

Fortunately, our accounting firms long ago saw the need to implement these regulations with all of their complexities and developed all sorts of computerized packages with spread sheets that require a minimum of input. In fact, one of the more popular ones is called section 861, a computerized tax system developed by none other than Price Waterhouse. I don't want to overpublicize their products, because other accounting firms have similar packages. But the point is that complexity is really not the issue here.

One further point about context. There has been a reference to DISC already. The Tax Code is rife with all sorts of incentives to export. And rife with all sorts of incentives for research and development. This provision is neither. This provision is simply an accounting rule that applies with equal force to interest expenses, to home office expenses, to the whole range of stewardship costs.

I'm not sure how many of you have ever had the misfortune of actually looking at this regulation, but it is some 58 pages in length. The R&D rules that we are talking about today are only one part. And as I sit here, I get a sense of *deja vu*, with all the arguments being made about gross sales and delayed costs. Mr. Chairman, we have heard it all before. And I assure you, if this allocation rule is repealed, that will not put the whole business of allocating expenses under the rug. All the other people who are irri-

tated by the provisions on interest expenses, home office expenses, legal and accounting fees, once they see that after 11 years of being frustrated at the Treasury Department, they can get relief from Congress, you will have them all lined up at the door. R&D is just one issue within the context of allocation.

The only principled response is to treat R&D the way all other overhead expenses are treated: allocate them between foreign and domestic sources.

Thank you.

Chairman RANGEL. Professor Bischel, would you care to respond?

Mr. BISCHEL. Well, I guess despite the fact that I esteem Mr. Kaplan's opinions very highly I could agree with his thoughts on allocation if in fact this allocation provision were not totally—as totally arbitrary as it is. It has no relationship at all to the factual standards with respect to which these expenses are initially incurred, and the ultimate sales to which they relate.

I might add as well Mr. Kaplan pointed out that in tax treaties nondiscrimination clauses are available. It has been my experience that as a practical matter they don't ordinarily get invoked. And there is only one tax treaty that we have, that with the United Kingdom, which specifically calls for the allocation of expenses such as research and development. The other treaties do not.

Chairman RANGEL. Mr. Desmond, would you care to close out this panel?

Mr. DESMOND. Only in the context that as was mentioned we had complexities and regulations and computer programs to do it. Yes, it is true, any calculation can be made. They do take a great deal of time. I mention that Price Waterhouse has assisted literally hundreds of companies in implementing these regulations. Let me assure you, it is a very complex job. R&D is the most complex in it. The gist of our comments despite the fact, as I mention, we support the thrust of legislation to encourage U.S. R&D and U.S. jobs, the real thrust of our testimony is to insure that guidance exists in the legislation to implement the spirit of the legislation so that we don't have the complexities we have seen in implementing the R&D provisions to date.

Chairman RANGEL. Thank you. Let me thank the three witnesses for the contribution that you have made to this discussion. Our last panel will be Glenn White, director of taxes and assistant treasurer of Chemical Manufacturers Association; and Ronald Danielian, executive vice president and treasurer of International Economic Policy Association.

The committee has your full statement. Without objection, if you care to summarize, your entire statement will be entered into the record at this time.

Mr. White.

STATEMENT OF GLENN W. WHITE, CHAIRMAN, TAX POLICY COMMITTEE, CHEMICAL MANUFACTURERS ASSOCIATION, AND DIRECTOR OF TAXES AND ASSISTANT SECRETARY, THE DOW CHEMICAL CO.

Mr. WHITE. Thank you, Mr. Chairman.

My name is Glenn White. I am chairman of the Tax Policy Committee of the Chemical Manufacturers Association. I will present a summary of my submitted statement.

Presently the allocation required by Treasury Regulation 861(8) is suspended by a temporary rule contained in section 223 of the Economic Tax Recovery Act of 1981. That suspension of the rule will expire at the close of 1983. We are here to testify on behalf of the extension of that rule.

The statutory result of the allocation required by the regulations is to tend to drive the taxpayer into foreign tax credit limitation. The real economic effect of that event is to disallow any deduction for research and experimental expenses once the business is in limitation. Of course, that operates as a strong disincentive for further research and experimentation in the United States by that firm.

In its June 1983 report, the Treasury Department acknowledged that economic effect. It said:

This cost increase—occasioned by the allocation—will have two separate but related effects on domestic R&D. First, it will increase the cost of the R&D relative to other investments and nonR&D inputs. Thus, it will tend to reduce domestic R&D spending even if a shift of R&D to foreign locations is impossible. Domestic R&D would tend to decrease because R&D in general has become more expensive.

Second, the increase in the marginal cost of domestic R&D represents an increase in the cost of domestically performed R&D relative to the cost of R&D permitted abroad. This might reduce the domestic share of the overall R&D performed by U.S.-based companies and their foreign affiliates.

The chemical industry has a vital interest in the continuing search for ideas that will contribute toward future expansion and productive capacity in the United States and develop new job opportunities.

In 1982, 3.6 percent of sales was spent by chemical companies for research. This percentage increased in 1983 to 3.73 percent.

The past several years, the chemical industry in the United States has shifted from the production primarily of basic chemicals to the substantial production of specialty chemicals. That production of specialty chemicals requires an extensive research effort. The chemical industry is a strong favorable contributor to the U.S. balance of trade. In 1982, the chemical industry exports exceeded imports by \$10.5 billion. In that same year, the merchandise trade balance showed a \$32 billion deficit.

A strong export position for the chemical industry is positioned upon an outstanding private sector research effort. It is important to understand, and I want to emphasize this, that our plea is not for a special advantage for research expenses, but only to insure that they may be at least treated as effectively deductible business expenses. To effectively deny the deduction is to effectively proscribe the activity in the United States.

Other nations offer strong incentives for the research and experimentation expenditures. For a taxpayer whose further expenditures for research in the United States will be denied even a tax deduction, a country that offers research incentives becomes extremely attractive. To the extent that research is done outside the United States, the technicians and scientists employed are foreign, the technology that is developed will also be foreign, and it is not unlikely that the plants in which the technology will be first employed will also be foreign.

The provisions of 861(8) work in direct opposition to the incremental credit for U.S.-based research and experimental expenditures. On one hand, the credit acts to create an incentive for research by lowering its costs while the allocation acts to deny any deduction for the cost.

In summary, the Chemical Manufacturers Association strongly believes that the moratorium should be extended. This action would prevent any reduction in research and experimental programs that might occur because of the additional cost when the Treasury rules are applied. Research programs have to be planned far in advance. Any uncertainty as to the law in the future will have a deterrent effect on long-range planning.

The Chemical Manufacturers Association recommends that the moratorium on the Treasury Department's regulation, section 861(8) be made permanent.

[The prepared statement follows:]

STATEMENT OF GLENN W. WHITE, THE DOW CHEMICAL CO., ON BEHALF OF THE
CHEMICAL MANUFACTURERS ASSOCIATION

Under the regulations of the Treasury Department, a portion of research and experimental expenses incurred in the United States by firms with overseas operations must be allocated to sources outside the United States. Presently that allocation is suspended by a temporary rule contained in section 223 of the Economic Tax Recovery Act of 1981 (ERTA). That suspension of the rule will expire at the close of 1983. We are here to testify on behalf of an extension of that rule.

My name is Glenn White and I am the Chairman of the Tax Policy Committee of the Chemical Manufacturers Association. With me is Mr. Robert Heyde, who is outside counsel to the Tax Policy Committee, and Mr. Robert B. Hill, who is the Legislative Representative for the Committee.

We strongly support extending the temporary rule embodied in section 223 of the Economic Recovery Tax Act of 1981 (ERTA) which allocates and apportions all research and experimental expenditures conducted in the United States to sources within the United States. We urge that Congress go further and make permanent the moratorium on the allocation of U.S. incurred research and experimental expenses. The Treasury Department's June, 1983, study of the impact of the research and experimental allocation has resulted in their recommendation that the moratorium be extended.

Without the moratorium, section 1.861-8 requires a taxpayer to allocate research and experimental expenses between foreign source income and United States source income based on a broad classification of 32 product groups enumerated in the Standard Industrial Classification Manual. This rule is highly complex and has a very arbitrary effect. In general, the allocation is determined on a ratio of foreign source sales and income to total sales and income. The statutory result of the allocation is to tend to drive the taxpayer into foreign tax credit limitation. The real economic effect of that event is to disallow any deduction for research and experimental expenses once the business is in limitation. Of course, that operates as a strong disincentive for further research or experimentation in the United States by that firm.

In its June, 1983, report, the Treasury Department acknowledged this economic effect. It said:

"This cost increase [occasioned by allocation] will have two separate, but related, effects on domestic R&D. First, it will increase the cost of R&D relative to other investments and non-R&D inputs. Thus, it will tend to reduce domestic R&D spending, even if a shift of R&D to foreign locations is impossible. Domestic R&D would tend to decrease because R&D in general has become more expensive. Secondly, the increase in the marginal cost of domestic R&D represents an increase in the cost of domestically performed R&D relative to the cost of R&D performed abroad. This might reduce the domestic share of the overall R&D performed by U.S.-based companies and their foreign affiliates."

The Chemical industry has a vital interest in the continuing search for ideas which will contribute toward future expansion in productive capacity in the United States and develop new job opportunities. The chemical industry is in the forefront

of research oriented activity. In 1982, 3.6 percent of sales was spent for research. This percentage increased in 1983 to 3.73 percent. Over the past several years, the chemical industry in the United States has shifted from the production primarily of basic chemicals to the substantial production of specialty chemicals. It is clear that this trend will continue, leaving less-developed countries as a primary source of basic chemicals. The production of specialty chemicals requires an extensive research effort, and this effort will accelerate in the coming years. The regulations as promulgated by the Treasury Department are detrimental to these goals.

The chemical industry is a strong, favorable contributor to the U.S. balance of trade. In 1982, chemical industry exports exceeded imports by \$10.5 billion. In the same year, the merchandise trade balance showed a \$32 billion deficit. The 1983 trade deficit will increase over the 1982 deficit by something more than 50 percent. In 1982, the chemical industry's exports dropped by 6 percent, while the industry's trade balance declined 12 percent. Current projections indicate a further drop in exports of 7 percent. A strong export position for the chemical industry is positioned upon an outstanding private sector research effort. As already indicated, the industry must increasingly export specialty products as gas-rich countries assume the commodity export markets. Development of specialty chemicals for the export market will occur only if a strong research effort is successful.

It is important to understand that our plea is not for a special advantage for research expenses, but only to insure that they may at least be treated as effectively deductible business expenses. The deductibility of research expenses is sound accounting practice and accords with Generally Accepted Accounting Principles. To effectively deny the deduction is to effectively proscribe the activity.

Other nations offer strong incentives for research and experimental expenditures. For a taxpayer whose further expenditures for research in the United States will be denied even a tax deduction, a country that offers research incentives becomes extremely attractive.

Moreover, to the extent the cost of research increases as a result of unfavorable tax impact, the effect will, in all likelihood, be to not do research in the United States. Probably the research will be done, possibly not even by U.S. enterprises but by non-U.S. concerns. U.S. based chemical companies must be competitive on a worldwide basis. Failure to remain competitive will not only imperil our export position, but will open U.S. domestic markets to import of foreign produced chemical products.

To the extent the research is done outside the U.S., the technicians and scientists employed are foreign. The technology that is developed will be foreign. It is not unlikely that the plants in which the technology will be first employed will be foreign.

The provisions in the 1.861-8 Treasury Regulations work in direct opposition to the incremental credit for U.S. based research and experimental expenditures. On one hand, the credit acts to create an incentive for research by lowering its cost, while the allocation acts to deny any deduction for the cost.

As a nation, we need a strong private sector research establishment. New technology is the source of continued economic growth and carries the seeds of jobs for the future. It is imperative that U.S. policy encourage domestic research activity.

In summary, the Chemical Manufacturers Association strongly believes that the moratorium should be extended. This action would prevent any reduction of research and experimental programs that might occur because of additional cost when the Treasury rules are applied. Research programs have to be planned far in advance, and any uncertainty as to the law in the future will have a deterrent effect on long-range planning.

The Chemical Manufacturers Association recommends that the moratorium on the Treasury Department's Regulation section 1.861-8 be made permanent.

Chairman RANGEL. Thank you.
Mr. Danielian.

STATEMENT OF RONALD L. DANIELIAN, EXECUTIVE VICE PRESIDENT AND TREASURER, INTERNATIONAL ECONOMIC POLICY ASSOCIATION

Mr. DANIELIAN. Thank you.

I am Ronald L. Danielian, executive vice president and treasurer of the International Economic Policy Association. I have a summary of my statement.

The International Economic Policy Association is a nonprofit, business-supported, research group based in Washington. For over a quarter of a century, we have analyzed public policy issues in the international economic arena. Our first involvement with international tax questions that affected the competitiveness of U.S. firms was before the Ways and Means Committee in June 1961, and we have consistently maintained that the health of American firms abroad and at home is one key to competing in the world.

The ability of U.S. business to retain capital and reinvest it for future growth is vital to remaining competitive in new product areas, to revitalizing traditional product areas, and to providing increased employment for the U.S. work force.

For a U.S. company, total net investable funds consist not only of those amounts earned in the United States, but also those earned abroad from assets located in foreign nations. These foreign assets are an integral part of the U.S. employment chain since one-third of U.S. exports go to American subsidiaries and affiliates abroad and investable funds flow back into the United States from dividends, branch earnings and royalties.

In fact, from 1948 through 1982, U.S. investments abroad returned—net of capital outflows associated with the investments—\$211.7 billion as shown in the table attached to my statement. The figure would be higher if royalty returns from unaffiliated foreigners are included. These returns are funds that can be used here in the United States to increase employment and maintain our competitive edge as we become more interdependent in the world today. And they also help our balance-of-payments.

The role of U.S. tax policy must include encouraging economic activity such as R&D and increasing employment here at home. At the very least, it should not hinder or jeopardize these goals. The Treasury has estimated that there would be a \$100 to \$240 million increase in tax liabilities if the moratorium were lifted. While this may be viewed as small, it means that the longstanding principle of eliminating double taxation would be broken. We do not believe it is in our interest to double tax capital which will constrict investment.

The Treasury study estimates a reduction in R&D spending of up to \$260 million. This translates into a job loss of up to 92,823 persons. That is a maximum outside limit. Any job loss would be distributed as follows: Nineteen percent in the Mid-Atlantic States—New York, New Jersey, and Pennsylvania—24 percent in the Pacific States—mainly California—21 percent in the East North Central States—mainly Ohio, Illinois, and Michigan—and 12 percent in the South—primarily the South Atlantic States and Texas.

Many studies have shown that for the most part R&D is undertaken in the market where it is used. Thus, we believe that just as income is taxed where earned, R&D should be allocated where undertaken.

As R&D is forced offshore, there will be a loss in income from royalties and fees by American parent companies. The balance-of-payments will suffer as the \$5.6 billion in royalties and fees from affiliated foreigners and the \$1.6 billion from unaffiliated foreigners is cut back. Furthermore, the nominal 46 percent taken by the U.S. tax man will be lost.

We believe that because of these reasons the moratorium under the 1981 act should be made permanent.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF RONALD L. DANIELIAN, EXECUTIVE VICE PRESIDENT AND TREASURER,
INTERNATIONAL ECONOMIC POLICY ASSOCIATION

Mr. Chairman, the International Economic Policy Association is a nonprofit, business-supported, research group based in Washington. Since 1957 it has analyzed public policy issues in the international economic arena. These have included international trade, investment and balance of payments issues, problems of natural resource vulnerability, and international tax questions that affect the competitiveness of U.S. firms. The health of American firms abroad and at home is a key to competing in the world today.

The ability of U.S. business to retain capital and reinvest it for future growth is vital to remaining competitive in new product areas, to revitalizing traditional product areas, and to providing increased employment for the U.S. workforce. For a U.S. company, total net investable funds consist not only of those amounts earned in the United States, but also those earned abroad from assets located in foreign nations. These foreign assets are an integral part of the U.S. employment chain, since one-third of U.S. exports go to American subsidiaries and affiliates abroad and investable funds flow back into the United States from dividends, branch earnings, and royalties. In fact, from 1948 through 1982, U.S. investments abroad returned (net of capital outflows associated with the investments) \$211.7 billion as shown in the attached table. The figure would be higher if royalty returns from unaffiliated foreigners are included. These returns are funds that can be used here in the United States to increase employment and maintain our competitive edge as we become more interdependent in the world today.

In an effort to maintain equitable tax treatment, U.S. companies operating abroad receive a credit for taxes paid to a foreign country. This, in essence, eliminates the imposition of double taxes on the same income, an objective that has been unquestioned by liberals and conservatives alike. Now, however, this principle is in jeopardy along with the goal of encouraging research and development and increased employment at home.

On May 27, 1983, Assistant Secretary of the Treasury for Tax Policy John Chapoton testified about extending the 25 percent tax credit for increased research spending that the Congress adopted in the Economic Recovery Tax Act of 1981. He said that this credit is of significant benefit to the United States because it encourages experimentation that may lead to innovations that enhance national productivity. He further indicated that the need for such activities cannot be disputed because innovation is essential if the United States is to retain and improve its competitive position in the world economy. We agree wholeheartedly with his view and believe strongly that that is the exact intent of legislation which makes permanent the moratorium on the arbitrary allocation rules established under Section 861 of the Regulations, as amended. This committee is reviewing whether or not to have still another two-year moratorium. Since this creates uncertainty for investment planning, we favor the approach of S-654 and H.R. 1887 to make the moratorium permanent.

When the cost of research and development here in the United States must be apportioned to foreign income, it reduces normally allowed credits for foreign taxes paid to foreign governments. Since foreign governments frequently will not recognize the validity of the allocation required by the Section 861 regulations, this raises the possibility of double taxation on the same income. It also reduces the available after-tax monies for further research and development expenditures and helps in shifting research and development offshore. At the same time that we are encouraging domestic R&D through the Economic Recovery Tax Act of 1981, we discourage it by an allocation of R&D expenditures to foreign-source income. For the lack of a consistent and coherent foreign economic policy, we have managed to create a curious "Catch 22" position.

Finally, if companies are forced to revert to the regulations, the results can produce allocations that defy logic. For instance, when a company performs U.S. ballistic R&D here at home and automotive parts R&D abroad, the U.S. costs must be allocated to the foreign automotive parts income because both activities are in the same SIC code. There are some alternative computations that can be used to try and

alleviate these kinds of conundrums but our members tell us that they are so complicated as to virtually negate their application.

This committee has already heard about the National Research and Development Study conducted by Arthur Anderson & Company which looks into the effects of lifting the moratorium on the Treasury Department's 861 regulations. A significant finding of the study was that "lifting the moratorium will encourage an expansion of foreign R&D investments in the future." We understand that some companies have decided to undertake new R&D Activities overseas, at least in part because of the possible effect imposition of the 861 regulations would have once the moratorium lapses. We do not believe this is good public policy.

A Department of the Treasury study entitled, "The Impact of the Section 861-8 Regulations on U.S. Research Development," completed in June of 1983, concludes with a statement that the Treasury recognizes the reduction in R&D may adversely effect the competitive position of the United States. "Accordingly, the Treasury supports a two-year extension of the present moratorium." More important, the Treasury study showed that there would be a \$100 to \$240 million increase in tax liabilities if the moratorium were lifted. While this may be viewed as small, it means that the longstanding principle of eliminating double taxation would be broken.

The Treasury study estimated that there would be a reduction of up to \$260 million in R&D spending. Using just this amount as a guide and based on National Science Foundation data, up to 92,823 persons would lose their jobs. Nineteen percent of this job loss would fall on the Middle Atlantic states (New York, New Jersey, and Pennsylvania), 24 percent on the Pacific states (mainly California), 21 percent on the East North Central states (mainly Ohio, Illinois, and Michigan) and 12 percent in the South (primarily the South Atlantic states and Texas).¹

We also believe that the Treasury study points to some inconsistencies. It states that it is appropriate on tax policy grounds to allocate domestic R&D to foreign sales even though such allocations can seem to be arbitrary as they are based on sales or gross income apportionment irrespective of where the R&D was performed.

However, the study quotas at length from several reports² which found that foreign R&D operations are usually created to serve and support foreign manufacturing. Only 20 percent of the cases investigated by Ronstadt involved R&D that was substitutable for U.S.-performed R&D. This relatively limited connection between U.S. and foreign R&D is also evident in the study by Jack Behrman and William Fischer. In looking at U.S.-Canadian R&D relationships, they found that the R&D typically had little overlap with the R&D program in the parent country. Thus, these studies indicate that R&D for the most part is undertaken in the market where it's going to be used and thus supports another principle that should be followed. We believe that just as income is taxed where earned, R&D should be allocated where it is undertaken. To do otherwise on an arbitrary formula basis does not approximate real world relationships and can create unwarranted hindrances on the market allocation of investable funds.

Finally, the Treasury study does not address the possible reduction of fees and royalties from the R&D research that it says would flow abroad as a result of the 861 regulations. At the present time, any research and development done in the United States but used abroad is generally paid for by those using it, whether or not they affiliated or unaffiliated with the originating company.³ On a parent-subsidiary basis, in 1982 the U.S. earned a total of \$5.6 billion in royalties and license fees, service charges and rentals (\$3.2 billion in royalties and fees alone). Furthermore, an additional \$1.6 billion was paid to U.S. companies from unaffiliated foreigners. It is safe to say this income stream (which is taxed in the United States when paid) could be reduced in the future if R&D was shifted to foreign locations. Instead, the foreign location host government would receive the tax revenues from the royalties and license fees obtained as a result of developing and selling the R&D. We believe the effect of this lost future income and tax was not considered in the Treasury study. In nominal terms, the United States collects 46 percent of the royalties and

¹The assumption is made that job loss would be proportionate to the distribution of R&D funds nationally based upon the latest detailed data for R&D by states and area in *Research and Development in Industry*, 1979, National Science Foundation, January 1980, NSF 81-324. This document is also available for 1980 (January 1981) but without regional breakdowns.

²Robert C. Ronstadt, "International R&D: The Establishment and Evolution of Research and Development Abroad by Seven U.S. Multinationals," *Journal of International Business Studies*, 1978; Jack Behrman and William Fischer, "Overseas R&D Activities of Transnational Companies," Oelgeschlager, Gunn & Hain, Cambridge, 1980.

³In line with the studies in footnote 2, such research and development used abroad is undertaken for the U.S. market in the first place and its foreign use is ancillary to its domestic development. This is also compatible with the product cycle theory of trade and investment.

license fees paid to the United States and this would certainly be jeopardized if R&D is forced abroad through these regulations.

While the R&D share of the U.S. gross national product turned up slightly in 1982, at 2.7 percent it is still below the 1964 high of 3 percent. *Business Week* has noted that "the proportion of civilian spending [on R&D], exclusive of defense and space research, probably still trails . . . competing nations" such as Japan or West Germany. A country that fails to maintain or in fact inhibits its R&D investments for the future, reduces its ability to compete and increase employment. We believe that the moratorium under the 1981 Act should be made permanent.

DIRECT INVESTMENT CAPITAL OUTFLOW, INCOME AND NET BALANCE, 1948-82

[In millions of dollars]

Year	Net capital outflow	Interest dividends br. earnings	Fees and royalties from affiliated foreigners ¹	Total income	Net balance of payments effect
1948.....	721	1,064	213	1,277	556
1949.....	660	1,112	220	1,332	672
1950.....	621	1,294	246	1,540	919
1951.....	508	1,492	272	1,764	1,256
1952.....	852	1,419	292	1,771	859
1953.....	735	1,442	305	1,747	1,012
1954.....	667	1,725	328	2,053	1,386
1955.....	823	1,912	373	2,285	1,462
1956.....	1,951	2,171	438	2,609	658
1957.....	2,442	2,249	446	2,695	253
1958.....	1,181	2,121	442	2,563	1,382
1959.....	1,372	2,228	543	2,771	1,399
1960.....	1,674	2,355	590	2,945	1,271
1961.....	1,598	2,768	662	3,430	1,832
1962.....	1,654	3,044	800	3,844	2,190
1963.....	1,976	3,129	890	4,019	2,043
1964.....	2,328	3,674	1,013	4,687	2,359
1965 ²	3,416	3,963	1,199	5,162	1,746
1966 ²	3,180	3,467	1,162	4,629	1,449
1967 ²	2,721	3,847	1,354	5,201	2,480
1968 ²	2,070	4,151	1,430	5,581	2,511
1969 ²	2,499	4,819	1,533	6,352	3,853
1970 ²	4,035	4,992	1,758	6,750	2,715
1971 ²	4,091	5,983	1,927	7,910	3,819
1972 ²	2,964	6,416	2,115	8,531	5,567
1973 ²	2,823	8,584	2,513	10,897	8,074
1974.....	1,275	11,379	3,070	14,449	13,174
1975.....	6,196	8,547	3,453	12,000	5,804
1976.....	4,253	11,303	3,531	14,834	10,581
1977.....	5,494	13,277	3,883	17,160	11,666
1978.....	4,713	14,115	4,705	18,820	14,107
1979.....	6,258	19,219	4,980	24,199	17,941
1980.....	2,205	20,129	5,780	25,909	23,704
1981.....	³ + 3,803	18,963	5,813	24,776	28,579
1982.....	³ + 8,331	17,565	5,572	23,137	31,468
Total.....	67,822	215,718	63,851	279,569	211,747

¹ Excludes fees and royalties from unaffiliated foreigners. A U.S. business presence abroad helps to acquaint foreigners with U.S. products and styling and sell our management skills and processes. Such fees and royalties amounted to \$15.4 billion from 1960-82.

² Excluding funds borrowed abroad for use by U.S. foreign companies which were included in the original outflow figures. Such funds were significant amounts during the period of U.S. direct investment controls (1968-72).

³ There was a net inflow from equity and intercompany accounts rather than outflows for investment because of selloffs of petroleum affiliates in Canada and Netherlands Antillean financing actions.

Source: Survey of Current Business, U.S. Department of Commerce, GPO, Washington, D.C., June 1981, 1983, March 1982 and other selected issues.

Chairman RANGEL. Neither one of you believe that there should be any allocation of R&D expenses overseas. Is that correct?

Mr. WHITE. That is my view.

Mr. DANIELIAN. I believe it should be deducted where it is undertaken.

Chairman RANGEL. Even if it is a part of doing business. If you need the research and development for your overseas operations, but it is done in one location, you should not attach any part of it as a business expense. You treat it as if it didn't exist as it relates to the overseas operation.

Mr. DANIELIAN. No. It exists and it can relate to the overseas operation but ultimately that operation will earn profits, and those profits will be returned to the United States and once they return they will be taxed.

Chairman RANGEL. OK. But you would not really include that research and development as a deductible expense for the overseas operations.

Mr. DANIELIAN. In the beginning the facts seemed to show that the research and development is done in the location where it is first used, generally speaking. So if it is done here in the United States, basically it was for U.S. purposes. Later on it might be used abroad.

Chairman RANGEL. So whatever is done in the United States for an overseas operation, should not be included as a part of doing business overseas?

Mr. DANIELIAN. I assume later on in the life of such research, 482 comes into play. I am not an expert tax lawyer.

Chairman RANGEL. You are saying that with all of the domestic expenses involved, we should wait until there is a profit overseas and that is where we should look?

Mr. DANIELIAN. Yes; and it should be allocated where undertaken, that is correct.

Chairman RANGEL. Now, there is a lot of talk, as one of the professors said, about how we are going to lose all of these R&D jobs here. Is there any evidence to point out really what U.S. firms, multinational firms, or these 24 firms look at in deciding where the R&D should be? Is there anything, other than just the threat that you would close up the U.S. R&D operation and move it to another country where conditions are more favorable?

That sounds great. And I don't know. And, of course, we are concerned about job loss. Is there anything that substantiates that if we just let the law expire that we should expect in the next few years U.S.-based R&D operations closing up and going to Europe?

Mr. WHITE. May I speak to that, Mr. Chairman.

Chairman RANGEL. I wish you would.

Mr. WHITE. I think anyone who claims that all the R&D jobs would be lost has grossly overstated the case. Obviously there are a great many factors that affect decisions as to where R&D will be undertaken. When a company is forced into a position where the next dollars that are spent on research are denied as deductions, and that is really the effect of the regulation as it operates, then the decision, the next time a capital investment for a research facility has to be made, is the weighing of the new facility in the United States versus the new facility in a different location.

If in fact there would be no deduction in the United States, and if that is weighed, as it often is, against a country that is delighted to have the research and will provide incentives for it—

Chairman RANGEL. We are only dealing with about 25 firms. How many countries are delighted to give incentives for R&D that would be competitive, assuming that this regulation expired?

Mr. WHITE. We find a rather attractive climate in Canada, the Netherlands, Germany, and France.

Chairman RANGEL. What percentage of the cost that would be affected would be located in these countries?

Mr. WHITE. I would think most of the companies—most of the companies cited as the 24—but I frankly cannot tell you. I know we are in all of those countries.

Chairman RANGEL. Generally speaking, your position indicates that if the Congress was to allow this to expire, most of the companies would receive more favorable treatment on R&D, wherever they located their overseas operations.

Mr. WHITE. The critical issue is that once the company is driven into limitation that the phenomenon comes into effect that it is more attractive to go somewhere else, even if there is only a deduction granted for the R&D. Because here if there is no deduction granted, it is not simply a matter of it being carried forward. But if the regulations stay in operation, the deduction would be effectively lost forever. And that is the critical element to us.

I can speak for Dow, for whom I am the director of taxes; it is a critical factor in the decision we have to make as to where to locate our future R&D facilities.

Chairman RANGEL. The problem some of us have is that you fellows are caught in a position that no matter what we do it would increase your tax liability. You have to be against it. No matter how committed we are to increase American jobs and increase R&D and to make us competitive against these foreign people, we would like to come up with a way to do that.

But you have to hold onto everything. In other words, it wouldn't make good client sense for you to say that we want the extension or want the regulation to be made permanent law. In other words, if we were talking about tax credits in the United States, which makes more sense to some of us, we could encourage Dow to think twice before you look at what other countries have to offer. If you do the R&D here, we would like to give you a credit against your tax liability.

Could you come up with anything to recommend to the subcommittee? This is assuming that you didn't have this allocation issue to work with as a lawyer or an accountant or business person?

Mr. WHITE. The problem is that to the extent we lose the ability to deduct the item at all, then the credit really isn't very attractive to us. Because the two policies run in complete opposition, one to the other. And so if we were to speak about what sort of incentive should we offer, there are lots of things you might consider as alternatives to what you have. But once the deduction itself is denied, or effectively denied for a significant part of the R&D expense, nothing else makes very much difference.

Chairman RANGEL. That is because basically we are dealing with firms that have high excess tax credits and who operate in high-tax countries. That is how we determine who is going to be affected really. So we have to come up with some general law or incentive

that would encourage R&D generally rather than specifically encouraging certain of our multinationals to do business here.

Mr. WHITE. I think one point that is quite important. Obviously a lot of the benefit flows to a small number of companies. But one of the reasons that is true is that those companies engage in a great deal of the research. For instance, Dow's research expenditure in 1982 was nearly \$350 million in the United States. That is nearly 1 percent of the \$37 billion of research that was cited in the Treasury report.

Mr. DANIELIAN. Mr. Chairman, the consistency of the policy should be that income should not be taxed twice, that you shouldn't be put in the position of having a double tax. And when you run into the excess credit position and you have an imposition such as the R&D allocation, the Treasury study shows that it would increase tax liabilities by, \$100 million to \$240 million. That might seem small. But you have breached that line of policy which is, you don't put somebody in the position of double taxation.

Chairman RANGEL. But there was nothing in that Treasury report that both of you are reciting that would indicate that there would be a transfer of the R&D abroad.

Mr. DANIELIAN. Not a transfer of existing R&D, that is true. But with regard to the marginal—the next dollar spent, there is an assessment or there is an indication that there would be R&D that would not be performed here in the United States, and they give a range of \$37 million to \$260 million.

Chairman RANGEL. We just don't know how you board members get together and decide where you are going to do your R&D. And it is hard to impress me that this is the controlling factor, especially with Dow Chemical.

Mr. WHITE. It is with us to the extent that the next dollar, or the marginal dollar that is related to a new investment in facilities, if we cannot get a deduction at all for the research dollars we spend, the research simply becomes too expensive to do.

Chairman RANGEL. Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Danielian, you testified that you recommend the 1981 R&D moratorium be made permanent.

Mr. DANIELIAN. Yes, sir.

Mr. PICKLE. And Mr. White believes that the moratorium should be extended. You go on to say that research programs have to be planned for in advance.

When you talk in terms of a moratorium, what timeframe are you talking about?

Mr. WHITE. The Chemical Manufacturers Association is requesting that the moratorium be made permanent.

Mr. PICKLE. When you make reference to moratorium, you mean a permanent moratorium and not a number of years?

Mr. WHITE. Yes, Mr. Pickle, that is true.

Mr. PICKLE. What do you think of a 2-year extension? Is that a sufficient moratorium?

Mr. WHITE. Well—

Chairman RANGEL. Depending on what options he has. That is not a fair question.

Mr. WHITE. Then it becomes a question of what will we do with the 2 years? Is the 2 years related to further study to find a better way to handle the problem? If that is the case, then certainly a moratorium is useful.

Chairman RANGEL. That makes a lot of sense.

Mr. PICKLE. Are you through?

Mr. WHITE. Yes, sir.

Mr. PICKLE. I am through, too.

Chairman RANGEL. Mr. Martin.

Mr. MARTIN. I have no questions.

Chairman RANGEL. Well, would you agree, Mr. Danielian, that because you believe the industry has a case to make and because there is some question as to what the losses would be—and we certainly don't want to lose U.S. jobs or the edge—rather than take a vote up or down, that maybe we should have a study for 2 years, extend the tax incentives, see where we are, and allow the industry to come forward and make a case as to whether or not it should be permanent?

Would you support that type of thinking?

Mr. DANIELIAN. Well, if that is the second best, Mr. Chairman, yes. Our position is that it should be made permanent because it still creates an uncertainty in the investment decisionmaking process.

There is a whole host of factors that go into making the investment decision on whether to locate a research facility here in the United States or abroad. This is just one of the items that would be considered. And to the extent that it hangs over them as an uncertainty, it does still present a problem. So our first best is that we believe it should be made permanent.

Chairman RANGEL. OK.

What the committee will do now is to recess for no more than 10 minutes and then resume our deliberations on this. I would ask the members that are present if we can go in the cloakroom just for a minute, and then we will come right back.

[Recess.]

Chairman RANGEL. The committee will stand adjourned until tomorrow morning at 10 a.m. when we meet in this room and vote on some recommendations on the matter before us. The committee stands adjourned.

[Whereupon, at 3:30 p.m. the hearing was adjourned.]

[Submissions for the record follow:]

MACHINERY & ALLIED PRODUCTS INSTITUTE,
Washington, D.C., October 25, 1983.

Hon. CHARLES B. RANGEL,
Chairman, Subcommittee on Oversight Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

DEAR CHAIRMAN RANGEL AND MEMBERS OF THE SUBCOMMITTEE: The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to present its views to the House Ways and Means Subcommittee on Oversight with respect to allocating and apportioning U.S.-performed research and development to U.S.-source income under Income Tax Regulation 1.861-8.

In brief, we favor congressional action to amend the Internal Revenue Code of 1954 to treat deductions for research and experimental (R&E) expenses attributable to activities conducted in the United States as allocable to income from sources

within the United States.¹ This would continue indefinitely a practice that was mandated for a two-year period by Section 223 of the Economic Recovery Tax Act (ERTA) of 1981. Section 223 of ERTA also directed the Treasury Department to conduct a study of, and provide recommendations to the Congress with respect to, the impact of the R&E allocation provisions of Income Tax Regulation (Regs.) Section 1.861-8 on research activities conducted in the United States and on the availability of the foreign tax credit.

As the Subcommittee may know, MAPI is the national organization of producers of capital goods and allied products. In that capacity, the Institute represents industries manufacturing and marketing the facilities of production, distribution, transportation, communication, and commerce. MAPI's membership includes corporations in a number of the most research-intensive industries in the United States, such as, machinery, including computers; electrical and electronic equipment; professional and scientific instruments; motor vehicles and related equipment; aircraft and missiles; and, to some extent, chemicals and allied products. The Institute's member companies produce highly engineered—often state-of-the-art-goods that are marketed worldwide, and their technological achievements and competitive positions are largely a function of their continuing commitment to R&E.

Elsewhere in the current Session of this Congress, we have commented in favor of bills to extend indefinitely the tax credit for increasing R&E activity and to bring about several tax changes that would benefit educational institutions through donations of certain allocation now in issue along with research incentives and various tax benefits to assist educational institutions, the Subcommittee will note—using the most recent National Science Foundation (NSF) and certain other studies—that (1) civilian U.S. R&E is lagging behind that of certain other major trading nations; (2) there is a large and growing gap between the demand for and supply of engineers in this country; and (3) our school system suffers from curriculum, facility, faculty, and other deficiencies, especially in mathematics and the sciences. In our opinion, these are interrelated phenomena and are leading indicators of economic deterioration in the absence of corrective measures. While we do not feel that the federal income tax should be called on to remedy every ill, U.S.-based R&E is a high priority matter and public policy should facilitate such activity rather than impede it.

As already indicated, ERTA contained a temporary policy to facilitate U.S. R&E by negating existing Regs. 1.861-8 as it pertains to R&E, and by requiring an exclusive apportionment of U.S.-performed R&E to U.S.-source income. In requiring such an apportionment, ERTA Section 223 avoids imposition on taxpayers of additional costs resulting from operation of the foreign tax credit limitation in respect of a domestic cost (i.e., R&E) that should not be related to foreign-source income as a general matter. Although a foreign tax credit limitation is designed to be operative in a system of worldwide taxing jurisdiction, the rules implementing the limitation should be reasonable, and be designed to interface smoothly with other taxing systems. MAPI supports a permanent extension of the allocation moratorium in ERTA 223 as being conducive to these ends, and urges adoption by Congress in the current Session for the following (summarized) reasons:

1. Existing U.S. R&E allocation rules—currently in suspense—raise the cost of domestic R&E and to some extent discourage such activity, contrary to the national interest.
2. Such allocation rules generally are not applied by foreign jurisdiction to their taxpayers, and the rules fail to take into account that foreign jurisdictions normally will not allow deductions locally for U.S.-performed R&E.
3. Such rules are contrary to the thrust of other tax policy favorable to U.S. R&E.
4. Allocating current U.S. R&E to foreign-source income does not reflect the tenuous connection between the two.
5. The existing allocation procedure is unnecessarily complex.

ERTA Section 223—as already mentioned—called for a special Treasury Department study and recommendations on this subject. The study in question was completed in June of this year. Although a detailed analysis of the document is beyond the scope of this presentation, it is reassuring that Treasury recognizes the exposure entailed in allowing the ERTA provision to lapse, and has supported a two-year continuation. More specifically, the study concludes with the following recommendation:

¹ We understand that H.R. 1887 of Congressman Cecil L. Heftel (D.-HI) would accomplish this. The counterpart measure in the Senate is S. 654, sponsored by Senator Malcolm Wallop (R.-WY) and others.

The Treasury Department recognizes that the reduction in R&D may adversely affect the competitive position of the United States. Accordingly, the Treasury supports a two-year extension of the present moratorium. This will provide Congress with an opportunity to consider the findings of this report while Congress and the Administration work to develop a coherent national program of R&D incentives.

Our more detailed comments in favor of legislation to extend the moratorium indefinitely constitute the remainder of this presentation.

BACKGROUND

Under Code Section 862(b), taxpayers with foreign-source income are instructed to deduct from the same the expenses, losses, and other deductions properly apportioned or allocated thereto, along with a ratable part of any expenses, losses, or other deductions that cannot definitely be allocated to some item or class of gross income. The remainder, if any, is to be treated in full as taxable income from sources within the United States.

This cost accounting procedure is significant in computations of taxable income under several provisions of the Code, but seems to arouse the most concern in connection with the foreign tax credit limitation under Section 904(a). Under that provision, the foreign tax credit is not to exceed an amount equivalent to the U.S. tax on worldwide income (before credits) multiplied by a limiting fraction, the numerator of which is foreign-source taxable income and the denominator of which is worldwide taxable income. To the extent that the numerator of the limiting fraction is reduced by apportionments of U.S.-incurred expenditures to foreign-source income, the foreign tax credit limitation is lowered, in some cases leaving taxpayers with unused credits and higher effective tax rates.

Allocation under the regulations

In 1966, IRS began an 11-year project to rewrite the regulations governing the allocation and apportionment of deductions to foreign-source income. This controversial project was completed in January 1977 with the promulgation of rather complicated amended regulations (i.e., Regs. 1.861-8) that generally have attributed more deductions to foreign-source income than in the past. As to R&E, amounts deducted under Section 174 ordinarily are considered to give rise to deductions which are definitely related to all income reasonably connected with the relevant product categories of the taxpayer, determined by the two-digit categories of the Standard Industrial Classification. Consequently, the deductions are allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such categories. Where R&E is not clearly identified with any product category, it is considered conducted with respect to all the taxpayer's product categories.

An exception applies for legally required R&E, which is to be allocated to gross income from the geographic area within which the requirements apply. This result follows if the R&E in question was undertaken solely to meet the legal requirements and if the results would not reasonably be expected to generate gross income (beyond de minimis amounts) outside of the geographic area where the requirements apply.

Apportionment by sales method

Apportionment of R&E via the "sales method" begins with an "exclusive apportionment" to the appropriate grouping of gross income from that geographic source where more than 50 percent of the R&E was performed. If the 50-percent test cannot be met, there is no exclusive apportionment. This exclusive apportionment is 50 percent in the case of a taxable year beginning during 1977; 40 percent for a taxable year beginning in 1978; and 30 percent for a taxable year beginning in 1979 and thereafter. Taxpayers may demonstrate to IRS that their exclusive apportionments should be higher, based on either very limited or long-delayed application of domestic R&E abroad. "Limited application" must be shown on the basis of commercial production of manufactured goods at the seven-digit SIC level by the taxpayer and certain controlled and uncontrolled persons. The "long-delayed application" test involves a comparison of the commercial introduction of the taxpayer's own products and processes in U.S. and foreign markets, not limited to those listed in the SIC, made by itself and certain controlled and uncontrolled parties.

The remaining apportionment to "statutory" and "residual" groupings of income—generally foreign-source income under Code Section 862 and domestic-source income under Section 861—within income classes after the exclusive apportionment involves a prorationing on a sales-to-sales basis. Amounts received from equipment leases during a taxable year are to be regarded as sales receipts for that year. Generally speaking, sales of uncontrolled parties must be taken fully into ac-

count where the sales involve intangible property licensed or sold by the taxpayer to them. In the case of controlled parties, there is a provision for the elimination of intercompany sales. Also, a controlled party participating in a bona fide cost-sharing arrangement for the purpose of developing intangible property is not expected to benefit from the taxpayers's share of the research expense.

Apportionment by gross-income method

As an option to the "sales method" of apportionment for R&E, a taxpayer meeting certain conditions can apportion on a gross-income basis. However, the amount of R&E apportioned to the statutory and residual groupings, respectively, cannot, in each instance, be less than 50 percent of the amount which would have been apportioned by the sales method.

ERTA

According to Section 223 of ERTA, U.S.-based R&E must be allocated to domestic-source income for all purposes for the taxpayer's first two taxable years beginning after August 13, 1981. Treasury was instructed to study and report back to the congressional tax-writing committees with recommendations concerning the R&E allocation provisions of Regs. 1.861-8. As indicated earlier, Treasury has recommended an additional two-year extension of the current moratorium pending efforts of Congress and the Administration to develop a coherent national program of R&E incentives. We urge Congress to extend the moratorium indefinitely, and are confident that such action will in no way interfere with other changes that may be undertaken in the national program of R&E incentives.

MORE DETAILED VIEWS

We believe that Congress should require that U.S.-performed R&E be allocated to domestic-source income for the additional reasons stated below.

Foreign tax credit limitation

As the Subcommittee may know, the R&E portion of Regs. 1.861-8 is placing more and more taxpayers in excess foreign tax credit positions. By frequently denying U.S. corporations a full allocation of domestic R&E expenses against domestic-source income and by assigning some portion to foreign-source income, even though it typically is not allowed as a deduction under foreign law, the regulation operates to reduce foreign tax credits because it reduces the numerator in the foreign tax credit limitation fraction under Code Section 904(a). Depending on the taxpayers' circumstances, the smaller fraction may mean that some portion of the taxpayer's income taxes paid abroad will not be creditable against its U.S. federal income tax liability. When this occurs, there is overlapping taxation because the same income has been subject to both U.S. and foreign taxation. The extent of R&E activity and the amount apportioned to foreign-source income may be such that a taxpayer's effective worldwide tax rate exceed the maximum U.S. statutory rate, even if the statutory rates elsewhere do not exceed those here.

It is difficult to rationalize an R&E allocation that raises effective tax rates by means of a cost accounting exercise that customarily is not performed by other countries asserting worldwide taxing jurisdiction; that disregards prevalent foreign government practices with respect to the nonallowability of deductions locally for costs incurred in the performance of R&E elsewhere; that puts taxpayers to extraordinary effort for the sake of an arbitrary allocation; and that, then, subjects taxpayers to higher liabilities for having performed the allocation. Consequently, we support the change mentioned earlier.

Policy conflict

In our opinion, Congress owes some attention to cross-currents that have evolved in tax policy with respect to R&E, and should eliminate the conflicts. For example, the current Administration and Congress seem genuinely aware of the need for competitive commitments of national resources to capital formation and R&E activity for the maintenance and improvement of the country's economic well-being. In that connection, we applaud such recent tax-policy initiatives as the Accelerated Cost Recovery System and the tax credit for increasing research activity. A modernized industrial base with more product and process innovations will go far toward restoring U.S. leadership in production and technology, and bring about the improvement in employment, income, and opportunity that always accompany such progress. There has been a "reawakening" in this context, but the R&E apportionment issue remains as a conspicuous and contradictory item of unfinished business.

More specifically, the R&E apportionment rule harks back to the mid-1970s when federal tax policy reached its apogee of severity in a well-meaning but unenlightened effort to generate revenues for unprecedented federal-spending growth. Regs. 1.861-8 was one of the most controversial tax-administrative projects ever undertaken by the federal government, and it culminated in a harsh promulgation partly because the issues were too arcane to attract general public interest and partly because of perceived "abuses" involving the foreign tax credit. In the short period of six to seven years since promulgation, attitudes have changed considerably, both as to tax burdens generally and—as already mentioned—policy with respect to capital formation and R&E in particular. Also, IRS has rearticulated the rules of foreign tax creditability in such a way as to lessen any susceptibility of the U.S. Treasury to unintended loss through the credit mechanism.

In our opinion, legislation such as we have recommended would eliminate an anachronistic tax-policy drag on U.S.-based R&E.

Beneficial relationships

One fundamental reason for confining the deduction for U.S.-performed R&E to domestic-source income is the fact that any income likely to arise from such R&E within a foreseeable timeframe is much more likely to be domestic-source than foreign-source. If the principle of matching of income and expense is to be followed and expense is to be attributed to income to which it is causally or beneficially related, then attributions to foreign-source income during the period of cost incurrence are almost an exercise in metaphysics. This is not to say that U.S.-based R&E cannot or does not ever give rise to foreign-source income. Rather, the point is, (1) that there is only a chance that research will give rise to any income; (2) that research cost incurred anywhere in one period generally will not give rise to any income until future periods; and (3) that U.S.-performed R&E is likely to produce income—if any—here before it yields income abroad.

Other accounting considerations

One of the first projects undertaken by the Financial Accounting Standards Board (FASB) was accounting for research and development. The result, FASB Statement No. 2, has the stature of "generally accepted accounting principles," and independent accountants who countenance departures from such principles without full and adequate justification are subject to censure. Although FASB deals in financial accounting rather than cost accounting, there are parallels that should be instructive in this instance. Put in the simplest terms, the question before FASB was whether R&E should be charged to income as a cost of the period when incurred or should be capitalized and written off against income arising from it in future accounting periods. The final decision was in favor of the former approach because of the futility of attempting to relate with any certainty R&E costs incurred in one period and future income streams—if any—associated with such costs.

Although IRS does not attempt under Regs. 1.861-8 to relate R&E cost to future periods, it undertakes the equally difficult task of partitioning R&E and assigning it currently to income from different sources for limitation purposes. The assignment is arbitrary, and fails to reflect the tenuous connection between current U.S.-based R&E and foreign-source income. Accordingly, we favor an apportionment of the entire amount to domestic-source income.

Complexity

Regs. 1.861-8 is a very complicated regulation, as borne out by the summary description of the R&E portion earlier in this statement, and we can say without exaggeration that the rule is a challenge to read and understand. Moreover, in order to comply, a taxpayer should know, among other things, (1) eligible R&E, where it is performed, in what amounts, and for what purposes; (2) product categories by two-digit—categories of the Standard Industrial Classification; (3) ranges of foreign product applications; (4) lag-times in foreign product introduction; (5) domestic and foreign sales by two-digit SIC categories; (6) data on certain intracorporate transfers from the parent company to subsidiaries or branches; (7) sales by purely wholesale or foreign affiliates; (8) various classifications of income, including sources; (9) factual relationships between deductions and income, taking into consideration at least six factors. Once this information is in hand, the taxpayer must carry out fairly detailed computations to determine the foreign tax credit limitations.

The overhaul of Regs. 1.861-8—of which the R&E allocation is simply the most controversial portion—was completed in 1977 and spanned 11 years. As promulgated in 1977, the amended regulation has been estimated by one commentator to be 70 times longer than the one it replaced. In our opinion, legislation of the type we have

recommended would simplify an unnecessarily complex area of tax administration, and should be viewed favorably in that light in addition to substantive grounds.

This concludes our comments concerning allocation and apportionment of U.S.-performed R&D. We thank the Subcommittee for the opportunity to present views on a matter of mutual interest, and hope that our thoughts on the subject will be useful.

Respectfully,

CHARLES W. STEWART,
President.

STATEMENT OF JAMES C. ROSAPEPE, WASHINGTON REPRESENTATIVE, MULTISTATE TAX COMMISSION

Mr. Chairman and members of the subcommittee, I am James C. Rosapepe, Washington Representative for the Multistate Tax Commission (MTC), an organization of 31 state governments that work together to improve the uniformity and efficiency of state taxation of business.

Federal tax regulations are not normally issues that draw comment from state tax officials. But Section 223(a) of the Economic Recovery Tax Act of 1981 (ERTA), which requires all U.S. research and development costs to be arbitrarily allocated to U.S. income regardless of where they generate profits, illuminates an issue of great concern to the states. That issue is proposed restrictions on state taxation of multinationals.

For several years, legislation has been introduced to bar the states from applying the "unitary method" of determining the in-state income of multinationals operating abroad through subsidiaries. In this Congress, that legislation is H.R. 2918 and H.R. 3001. Congressional proponents of these bills, and their occasional allies in the Treasury Department, argue passionately that the "unitary method" distorts the measurement of in-state income. They claim that, by looking at the total profitability of each multinational and then apportioning its income to each state based on the firm's relative payroll, sales, and investment there, the "unitary method" does not accurately measure profits actually made in each state.

These critics of the "unitary method" want to impose on the states the "arm's length method" supposedly used by the federal government. Under "arm's length," a multinational is asked to pretend that its subsidiaries deal with each other on the same terms that the multinational trades with independent companies. To police this system, the Internal Revenue Service (IRS) is required to audit millions of transactions between subsidiaries to assure that they were handled on an "arm's length" basis.

Even champions of the "arm's length" approach admit it is an administrative nightmare. John Chapoton, Assistant Secretary of the Treasury for Tax Policy, recently told a group of Washington financial reporters, "the arm's length method . . . is very difficult to administer." Mr. Chapoton also noted that, despite the large staff of the IRS, "We have a heck of a time administering it (arm's length)."¹ The system's popularity with many multinationals suggests its status as a tax avoidance, rather than tax collection, technique. The recent cases of Marc Rich and Co. and Toyota, both accused of using the method to avoid U.S. income tax, underline its failure. Finally, the General Accounting Office, in a 1981 study, discovered that, IRS audits could find "arm's length" prices in only 3 percent of the cases they reviewed.²

Aware of this dismal record, states are understandably unenthusiastic about being forced to use the "arm's length method." Yet proponents of federal restrictions on state use of "unitary" insist that the states can rely on the federal government to correct problems in enforcement of "arm's length." With its own tax revenue at stake, does not the federal government have even more incentive than the states to ensure that the "arm's length method" accurately measures U.S. income?

Evidently not, if Section 223(a) of ERTA reflects federal policy.

This provision, shielding U.S. income from U.S. tax by artificially allocating all U.S. R&D expenses of multinationals to U.S. income (even when the R&D creates foreign profits), explicitly distorts the measurement of U.S. and foreign income. At a cost of \$100 to \$240 million (85 percent of which goes to just 24 multinationals), the

¹ Frank Gresock, "President Will Not Ask High Court to Reconsider Unitary Tax Ruling," *Daily Bond Buyer*, September 26, 1983.

² U.S. General Accounting Office "IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations," September 30, 1981, page 29.

federal government rejects any attempt to accurately measure U.S. income.³ If a state manipulated its apportionment formulas in such an arbitrary manner to raise revenue, it would be accused of "double taxation," "distortion," and "taxing foreign income."

Certainly there is irony, if not hypocrisy, in officials claiming "arm's length" measures income more accurately than "unitary" and simultaneously supporting an allocation method that artificially inflates reported "foreign income."

More importantly, Congress' action in 1981, and Treasury's support of its continuation for another two years, shows graphically why the states cannot rely on federal use of "arm's length" to assure accurate measurement of foreign income. Even assuming that compliance with the theory of "arm's length" is high (and the Marc Rich and Toyota cases raise serious questions about that), Section 223(a) demonstrates that the federal government does not even try to accurately measure which profits are made in America.

Without the will and, according to GAO, without an effective way to accurately measure U.S. income, the federal government simply cannot guarantee the states that replacement of "unitary" with "arm's length" will lead to anything but special tax breaks for a small number of multinationals.

PHARMACEUTICAL MANUFACTURERS ASSOCIATION,
Washington, D.C., November 15, 1983.

HON. CHARLES B. RANGEL,
Chairman, Committee on Oversight, Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of the Pharmaceutical Manufacturers Association, I am pleased to submit the attached statement, entitled "The Need To Make Permanent The Moratorium On Allocating Domestic R&E Spending To Foreign Source Income," and dealing with Regulations 1.861.8 of the Internal Revenue Code. This statement addresses issues raised at recent hearings by the Subcommittee on Oversight on "Research and Experimental Source Allocation Rules," and relating to H.R. 1887, by Representative Heftel, which would make U.S. research a charge exclusively against domestic source income for U.S. tax purposes. We request that this statement be included in the record of these hearings by the Subcommittee.

PMA is a nonprofit scientific and professional organization representing firms that discover, develop and produce most of the prescription drugs used in the United States, about half the free world's supply of drugs, and a large part of the world's medical devices and diagnostic products. Major long-term investments by these firms in research and development are required to sustain this activity. We believe that enactment of provisions based on H.R. 1887 and incorporated in general tax legislation would be a highly important step toward removing disincentives to domestic R&D investment, thereby enhancing the competitive position of high technology companies which make a major contribution to United States economic growth.

Sincerely,

LEWIS A. ENGMAN,
President.

Attachment.

STATEMENT OF THE PHARMACEUTICAL MANUFACTURERS ASSOCIATION

THE NEED TO MAKE PERMANENT THE MORATORIUM ON ALLOCATING DOMESTIC R&E SPENDING TO FOREIGN SOURCE INCOME

Regulation 1.861.8 of the Internal Revenue Code

The Pharmaceutical Manufacturers Association endorses H.R. 1887 which would make U.S. research a charge exclusively against domestic source income for U.S. tax purposes. It is felt that such a change will act as a stimulant for research in the United States.

The problem

For the purpose of computing U.S. tax liability, Treasury Reg. Section 1.861.8 requires corporations with foreign operations to allocate or apportion expenses, losses,

³ U.S. Department of the Treasury, "The Impact of the Section 861-8 Regulation on U.S. Research and Development," June, 1983, p. 32.

or other deductions between domestic and foreign source income. This regulation, promulgated by the Treasury Department in 1977, requires that a portion of U.S. research and experimental (R&E) expenditures be allocated to foreign source income. Foreign governments do not recognize this allocation as a deduction in computing their income tax. The effect, as noted in the Treasury Department's June 1983 report on "The Impact of the Section 861-8 Regulation on U.S. Research and Development," is to increase the over-all U.S. plus foreign tax, liability of U.S. companies engaged in research in the United States.

The allocation rule is a disincentive to U.S. research. For example, to the extent U.S. companies plan to increase their U.S. research in response to tax credits for incremental research, they are faced with the prospect of creating unusable excess foreign tax credits. A company wishing to increase both its worldwide business and its U.S. research—both laudable goals from an overall U.S. economic standpoint—faces not a tax incentive, but a disincentive. Given the incentives provided for research and development by foreign nations, this regulation makes U.S. R&E investment relatively less attractive to U.S. companies than conducting such activity abroad.

Recognizing the inequities created by the 1977 regulations, Congress in the Economic Recovery Tax Act of 1981 placed a two-year moratorium on the R&E allocation requirements of Section 1.861-8. This moratorium expires this year.

To avoid reimposition of this regulation, Congress should enact legislation to eliminate permanently such allocation requirements.

The Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, at the hearings on H.R. 1887 held October 26, 1983, before the Subcommittee on Oversight of the House Committee on Ways and Means, stated:

"The allocation of R&E expenses to foreign income, however, may increase the cost of domestic R&E and interfere with the objective of a stronger technical base for the U.S. economy. The allocation of R&E to foreign income also raises difficult technical issues on the specific contribution of domestic R&E to foreign income."

We concur with those observations and submit that the highly theoretical allocation concepts and detailed rules for implementation in the now suspended regulation constitute a burden on domestic research, creating a conflict between expanding worldwide markets and expanding domestic research.

We wish to stress the fact that the present and future impact of these regulations is not confined to a limited number of companies. The Treasury Department, in its recent report, emphasized the effect of the moratorium on companies already in the position of having excess foreign tax credits. However, the widespread basis for concern over these regulations lies in the fact that continued application of these regulations will bring many more companies into an excess foreign tax credit position. The smaller companies today must take into account the fact that as they grow and become international competitors they will experience the same adverse impact of the regulations. Inevitably they must consider this negative result in their long-term planning for their research and investment.

The Treasury also alluded in its testimony to the practices of foreign countries, noting the understanding that most foreign countries do not have detailed rules for allocating expenses, including domestic research expenses, to foreign income. We believe that this is a correct summary of foreign tax laws and we would point out that those countries thereby avoid a tax disincentive to increased domestic research in those countries.

We also note the Treasury suggestion that foreign country tax practices are generally not taken into account in determining U.S. tax liability and that, therefore, the refusal of foreign countries to allow deductions for bona fide cost sharing payments by U.S. affiliates to U.S. parent companies for U.S. based research expenses should not affect the application of U.S. rules. We submit that, to the contrary, where the effect of the U.S. allocations and the foreign denial of deductions creates a disincentive to incur U.S. research costs, the U.S. should not be promulgating such allocation rules in the absence of a significant degree of acceptance of such rules by foreign countries, whether through treaties or through agreement of intergovernmental tax organizations in which the U.S. participates, such as the OECD Committee on Fiscal Affairs and regional organizations of tax administrators. Such international agreement on allocation rules for research expense and cost sharing simply does not exist today.

In his testimony Assistant Secretary Chapoton recommended an additional two-year moratorium on allocations of research expense to foreign income.

Because investment in R&E is a long-term commitment requiring confidence in a stable investment climate, an extension of the moratorium will not be sufficient. If companies are to commit necessary resources to research and development, they

must be confident that their tax treatment will not be adversely altered in another two years.

PMA urges that provisions based on H.R. 1887 be promptly enacted and end the uncertainty that surrounds this issue.

DISCUSSION

Declining rate of R&D investment

By a variety of measures, the U.S. has experienced a slowdown in growth in R&D activities. The National Science Foundation (NSF) reports that average annual growth in U.S. R&D spending in constant dollars was 4.7 percent between 1960-1969, and 2.3 percent between 1970-1981.

The NSF also calculates that basic research as a percentage of total industrial R&D expenditures has gradually declined from 8 percent in 1960 to 4.5 percent in 1982.

Compared to other countries, U.S. R&D spending increased have been less:

CIVILIAN R&D EXPENDITURES AS A PERCENT OF GNP

Year	Country		
	United States	Japan	West Germany
1969.....	1.5	1.6	1.8
1975.....	1.5	1.9	2.2
1981.....	1.6	2.1	2.5

Source: National Science Foundation.

A recent survey of 85 major companies by Arthur Andersen & Co., the worldwide accounting firm, found that:

Most corporations have shown an increase in their foreign R&D expenditures as a percentage of their worldwide R&D expenditures over the past ten years. Those companies with less than \$2.5 billion in sales exhibited the greatest percentage increase in foreign to total R&D.

The percentage increase in foreign to total R&D expenditures exceeded the percentage change in the ratio of foreign sales to domestic sales.

Employment of highly skilled scientists and engineering professionals increased faster abroad than in the U.S.

Various government incentives and disincentives were a major factor in the allocation of R&D resources in the industries studied. Forty-four percent of the respondents noted that if the moratorium on Section 1.861.8 were lifted, the regulation would contribute to an excess foreign credit position in coming years. Thirty-five percent said that this had been the case in 1977 through 1980. The study notes that the regulation tends to "impede R&D expansion in the U.S. by increasing the cost of R&D and reducing cash flow available for R&D investment as a result of greater corporate tax liabilities."

The impact to R&D on productivity and trade

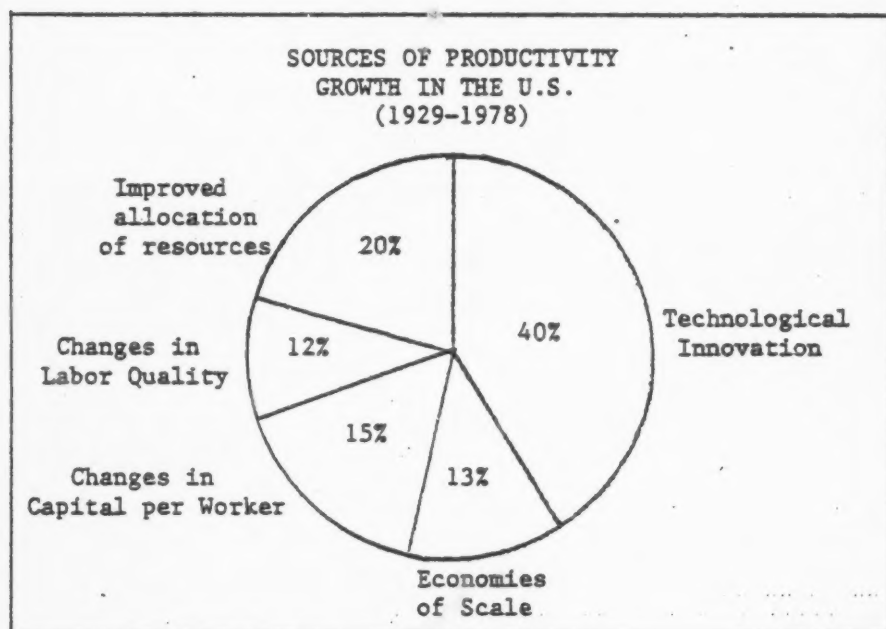
Technological innovation exerts a strong, positive influence on economic growth. High technology industries—pharmaceuticals, advanced electronics, chemicals—have experienced more growth, sustained higher productivity and employment rates, and have been more competitive internationally than have industries with low technological activity.

According to the Committee for Economic Development, "Firms that have invested heavily in developing technology and carrying it forward into commercial products have been shown to have about twice the productivity rate, three times the growth rate, nine times the employment growth, and one-sixth the price increases of firms with relatively low investment in these activities."

Economist John W. Kendrick of George Washington University notes, "In modern economies the most important force behind productivity growth is technological progress resulting from cost-reducing innovations in the ways and means of production."

Kendrick's analysis of productivity inputs between 1929 and 1978 indicates that fully 40 percent of productivity growth during that period was due to "advances in knowledge" or technological innovation attributed to: formal R&D programs; informal inventive and innovative activities of individuals and groups included in R&D

statistics; and the rate of diffusion of new process and producers' goods throughout the economy.



Adapted from John Kendrick's Analysis

There is compelling evidence that increased R&D leads to a stronger trade position. Economist D.B. Kessing attributes 88 percent of the variation in export share to variation in R&D levels in 18 U.S. manufacturing industries.

U.S. TRADE BALANCE (EXPORTS LESS IMPORTS) IN R&D-INTENSIVE AND NON-R&D-INTENSIVE MANUFACTURED PRODUCTS GROUPS

[In millions of dollars]

Years	R&D-Intensive	Non-R&D-Intensive
1977	\$27,627	-\$24,378
1975	29,344	-9,474
1973	15,101	-15,370
1971	11,727	-11,698
1970	11,722	-8,285
1965	8,148	-2,027
1960	5,891	-179

Note.—(R&D-intensive industries are defined as having at least 2.5 percent of their work force employed as scientists or engineers engaged in R&D and making R&D expenditures equal to at least 3.5 percent of net sales.)

Foreign tax advantages and other incentives

High technology companies are facing increasingly intensive competition from their Western European and Japanese counterparts. Those countries that have been our most successful competitors have solid government policies to stimulate and support technological development and trade.

As the recent Arthur Andersen study on "National Research and Development" notes, many of our major foreign competitors provide significant tax incentives for R&D activity, including additional deductions and tax credits of incremental research and for the acquisition of assets used for research, as well as providing sig-

nificant non-tax incentives. In some countries, outright cash grants are provided for construction of research facilities.

Impact on U.S. pharmaceutical industry

The effect of Regulation 1.861-8 leads to an increase in a U.S. company's over-all tax liability. The Arthur Andersen study points out that research-intensive companies are particularly adversely affected by this regulation. U.S. pharmaceutical companies which conduct about 80 percent of their R&D in the U.S., although they derive about 50 percent of sales from abroad, feel a significant additional tax burden and a dampening of R&D investment incentive as a result of this regulation.

The pharmaceutical industry is highly research-intensive. The industry consistently spends about 11 percent of its sales on R&D, compared to two percent for industry generally. In 1980, Pharmaceutical Manufacturers Association members spent about \$1.5 billion on research and development in the U.S.

In 1982, the U.S. pharmaceutical industry contributed \$1.7 billion to our balance of trade.

However, the research efforts and innovational output of U.S. pharmaceutical firms have deteriorated relative to their Western European and Japanese competitors. The annual growth rate in constant dollars for R&D in the U.S. from 1973 to 1979 was 1.1 percent. In the United Kingdom, it was 13.1 percent; in West Germany, 7.9 percent; and in Japan, 8.1 percent.

According to the Organization for Economic Cooperation and Development, the U.S. pharmaceutical industry has suffered a significant deterioration in its international competitive position. Even more troubling, the study predicts that, in light of the declining rate of growth in this country's R&D, this deterioration will probably continue.

Conclusion

Considering the vital link between R&D investment and economic growth, the U.S. requires a tax program that stimulates rather than dampens technological development. Passage of a law permanently lifting the regulation that a portion of U.S. research and development spending be allocated to foreign source income would be a significant stimulus to domestic R&D investment by U.S. companies. H.R. 1887 would support this crucial activity and enhance the competitive position of those high technology companies on which the United States depends for economic growth.

STATEMENT OF THOMAS P. MALETTA, VICE PRESIDENT OF TAXES, ALLEGHENY INTERNATIONAL, INC., ON BEHALF OF THE TAX COUNCIL

I am Thomas P. Maletta, Vice President-Taxes for Allegheny International, Inc. I am speaking today on behalf of the Tax Council, a business organization dedicated to the active improvement of federal tax and fiscal policy to accommodate and encourage real economic growth, higher productivity, and greater employment. The industries represented in the Council cover a broad spectrum including heavy and light manufacturing, mining, energy, electronics, transportation, public utilities, consumer products and services, retailing, public accounting, banking and all other forms of financial service. Because research and development is so fundamental to all business enterprises, the diversity of our membership uniquely qualifies us to comment on these proposals before this committee.

The Tax Council has always recognized the important role played by research and development in maintaining a healthy and growing economy. R&D is a prerequisite for the development of new products and production techniques, as well as for the maintenance of a competitive trade position within the world economy. In addition, the technological growth and innovation which results from R&D is essential to sustained economic growth which improves our standard of living and reduces inflationary pressures. The Council is very concerned that the United States may be losing its lead in the development of new technologies to foreign countries. According to a recent study by the National Science Foundation, the average annual growth in U.S. R&D expenditures during the 1970s was 2.3 percent compared with 4.7 percent during the 1960's. This dangerous trend must not be allowed to continue. We feel that this trend has, at least in part, been caused by poorly conceived tax policies which have discouraged domestic R&D and encouraged the transfer of domestic R&D abroad. Therefore the tax Council strongly endorses H.R. 1887 and S.654 which would correct for these policies by amending Sections 861 and 862 of the Internal Revenue Code to require that all expenditures for domestic R&D be allocated exclusively to U.S. source income for tax purposes.

In 1977, the Treasury Department issued a complex set of regulations requiring that a portion of domestic R&D expenditures be allocated to foreign source income for tax purposes. In 1981, Congressional concern that these provisions were discouraging domestic R&D and creating an incentive for U.S. firms to transfer R&D abroad led to a 2 year moratorium on the allocation of domestic R&D expenditures to foreign source income. This moratorium is due to expire at the end of the 1983 calendar year and absent any further legislation, Section 861 allocation requirements will be reimposed at that time. Although the moratorium contained in ERTA was a good first step towards correcting for the disincentive against domestic R&D inherent in Section 861, we feel that it is absolutely essential that this moratorium be made permanent if we are to regain our leadership role in the development of new technologies.

The fundamental problem with Section 861 is its interaction with the foreign tax credit limitation. By requiring domestic R&D expenditures to be deducted from foreign source income for tax purposes, the amount of the tax credit that may be claimed for taxes paid to a foreign government is reduced. Yet in most instances, the amount of foreign taxes actually paid will not be reduced because the foreign taxing authorities do not consider expenditures made for R&D in the United States to be a deductible cost of doing business within their country. As a result of this, corporations with foreign operations are unable to claim a full foreign tax credit and therefore face a higher worldwide tax burden. The ultimate effect of this is to reduce the benefits that a corporation derives from domestic R&D. The corporations that are most seriously affected by this are those with substantial international operations and those in the technology intensive industries, both of which the health of our economy depends on.

Expiration of the current moratorium without the enactment of corrective legislation would result in the reimposition of Section 861 allocation requirements, creating an incentive for U.S. corporations to transfer their R&D operations to foreign countries where they are able to claim a full deduction for these expenditures. A recent study conducted by Arthur Anderson and Co. on the impact of Section 861 on domestic R&D concluded that this has been the trend. According to this study, the percentage of foreign R&D to worldwide R&D has increased dramatically over the last 10 years for most corporations. This movement of R&D out of the United States has been furthered by the active efforts on the part of foreign governments to encourage and attract R&D. It should be noted that the United States is the only country that requires the allocation of domestic R&D expenditures to foreign income for tax purposes.

Mr. Chairman, The Tax Council feels that we cannot afford to stand by idly as R&D leave our shores for foreign countries with which we must compete. Currently, our competitive position is slipping in large part due to our inability to compete in the new high technology industries in which we have lost our edge to foreign countries which have actively encouraged and promoted R&D within their borders. It is essential if we are to maintain a competitive trade position that we increase the amount of R&D performed in this country.

According to a recent study put out by the Office of Tax Analysis of the Department of Treasury, product groups which are R&D intensive have experienced large trade surpluses over the last twenty years while non-R&D intensive product groups have experienced substantial deficits. With a current trade deficit of \$60-70 billion, now is not the time to take any action which will further aggravate this situation by handicapping our R&D intensive industries.

We feel that it is imperative that we formulate and adopt a set of long-term policies for encouraging domestic R&D. In addition to making our products more competitive abroad, a higher level of domestic R&D would stimulate overall economic growth increasing our standard of living and reducing inflationary pressures. Crucial to such policies is favorable tax treatment for expenditures made for domestic research and development as contained in H.R. 1887 and S. 654 which would make permanent the tax treatment afforded R&D under the current moratorium. Although this moratorium was a vast improvement over Section 861, the temporary nature of the provision prevented it from having as significant an impact as a more permanent provision would have had. Many R&D projects take as long as ten years before they produce a marketable product, process, or technique. Consequently, the decision to undertake an R&D project, especially a long range one, is highly sensitive to perceptions of what the future business environment will be. Any provision which is temporary in nature will create considerable uncertainty. Undoubtedly, this certainty has discouraged many projects which would have been undertaken had the current moratorium been made permanent from the beginning. For this reason, it is very important that the tax treatment of money spent here in the

United States on R&D be made permanent rather than merely extended for a limited period of time.

Another issue of concern to us is the amount of attention that has been given to the distribution of the benefits yielded by the current moratorium. We feel that this has diverted attention away from the real issue before us which is how to increase U.S. R&D. The suggestion that a large portion of the benefits of the moratorium accrue to a few corporations is very misleading for several reasons. First, these corporations derive those benefits because they have substantial R&D operations. Second, R&D is a process is subject to very large economies of scale. Economic efficiency will naturally tend towards its concentration among a few corporations. Therefore it would be counterproductive to the goal of increasing R&D to enact any legislation penalizing firms with large R&D operations. We would hope that this committee would realize that the concentration of R&D tax credit benefits among a few corporations is not indicative of an inappropriate or inequitable tax policy, but rather a tax policy which recognizes economic realities.

To summarize, Mr. Chairman, The Tax Council feels that the recent trend in U.S. R&D is very disappointing and that the continuance of this trend poses a serious threat to our future economic health. Without strong national policies to encourage domestic R&D by U.S. companies, U.S. corporations will find it more difficult to compete with those of foreign countries which have vigorously promoted R&D within their borders. We would hope that the Congress would not allow marginal short-run revenue gains to persuade it into making a decision with the long-run detrimental effects on the American economy that the failure to enact this legislation would have.

We must realize that when R&D leaves our shores, the hope for our economic future goes with it. Therefore, at a time when there is such widespread public concern about our deteriorating economic base, our inability to compete internationally in the new high technology industries as well as the more traditional smokestack industries, failure to enact the proposed legislation, which would result in the reimposition of Section 861 allocation requirements by default, is clearly the wrong move at the wrong time. We believe that the expiration of the current moratorium provides the Congress with an excellent opportunity to take a positive step towards future growth and world competitiveness.

We thank you for this opportunity to share our views with you.

TAX EXECUTIVES INSTITUTE, INC.,
Arlington, Va., October 21, 1983.

Hon. CHARLES B. RANGEL,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, Longworth
House Office Building, U.S. House of Representatives, Washington, D.C.

DEAR CHAIRMAN RANGEL: Tax Executives Institute, Inc. submits this statement for inclusion in the record of the Subcommittee's October 26, 1983, hearing on research and experimental source allocation rules. As explained in detail below, Tax Executives Institute endorses legislation providing that, for purposes of section 861(b) and section 862(b) of the Internal Revenue Code, all amounts allowable as a deduction for research and experimental expenditures (within the meaning of section 174 of the Code) attributable to activities conducted within the United States are to be allocated to sources within the United States. We urge the Subcommittee to act promptly on such legislation so it might be enacted this year.

BACKGROUND

Tax Executives Institute (TEI) is a professional association of corporate and other business executives who are responsible for the tax affairs of their employers. Our 3,800 members work for approximately 2,000 of the leading corporations in the United States and Canada.

No single industry dominates TEI. We represent a cross-section of the business community and believe our diversity and dedication to the tax function qualify us to address issues concerning the administration of the tax laws and the effective implementation of tax policy. As the principal association of tax executives in North America, TEI is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the nation and to reducing the costs and burdens of administration and compliance to the benefit of government and taxpayers alike.

THE NEED FOR PERMANENT LEGISLATION

TEI supports legislation providing that all amounts allocable as a deduction for research and experimental expenditures (within the meaning of section 174) that are attributable to activities conducted within the United States are to be allocated, for purposes of sections 861(b) and 862(b), to sources within the United States. Such legislation would have the effect of rendering invalid section 1.861-8 of the Treasury Department's income tax regulations, which contains rules for allocating and apportioning such amounts between U.S.-source and foreign-source income, thereby making permanent a moratorium on the application of those regulations which Congress passed as part of the Economic Recovery Tax Act of 1981. Unless Congress acts, the moratorium will expire (for calendar year taxpayers) at the end of 1983. The moratorium should be made permanent, and legislation effecting that result should be enacted before the end of year.

Under Treas. Reg. § 1.861-8 (before enactment of the congressional moratorium), when a taxpayer performed research activities in the United States, a portion of the tax deduction for expenses attributable to that research would be allocated to the taxpayer's foreign-source income. In certain cases this allocation would have the effect of denying the taxpayer a foreign tax credit on that income, thereby effectively depriving the taxpayer of the benefit of that portion of the deduction in the United States.

The allocation rules currently contained in Treas. Reg. § 1.861-8 represent a clear disincentive to the performance of research and experimental activities in the United States as opposed to European and other countries. The effect of allowing the moratorium on applying Treas. Reg. § 1.861-8 to expire, therefore, would be to undermine the policy underlying Congress's decisions (evidenced by the enactment of the research tax credit) to favor research conducted within the United States.

In its June 1983 report on the effect of the section 1.861-8 regulations, the Treasury Department acknowledged that the regulations (if allowed to go into effect) would have a dual adverse effect: not only, as discussed above, would they cause some research to be conducted abroad rather than in the United States, but they would also reduce the overall level of research activities. According to the Treasury's estimates, in 1982 domestic R&D spending would have been between \$40 million and \$260 million less if the section 1.861-8 regulations had been in effect. We believe the Treasury's estimates understate the negative effect of the regulations.

The Treasury Department has endorsed a temporary, two-year extension of the present moratorium on the ground that additional time is necessary to study the issue. TEI submits, however, that given the clear disincentive to domestic research that the regulations represent, permanent legislation would be preferable. Consequently, we urge Congress to amend the Code to provide that, for purposes of sections 861(b) and 862(b), all research and experimental expenditures attributable to activities conducted within the United States are to be allocated to sources within the United States. We strongly urge, moreover, that such legislation be enacted this year—before the current moratorium is scheduled to expire.

CONCLUSION

Tax Executives Institute commends the Subcommittee for holding a hearing on this important issue and appreciates the opportunity to present our views. If we can be of any assistance to the Subcommittee, technical or otherwise, please do not hesitate to let us know.

Respectfully submitted,

PAUL A. BARRESE,
President.

APPENDIX

LETTER OF TRANSMITTAL

SUBCOMMITTEE ON OVERSIGHT,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C., November 9, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This letter transmits the report and recommendations of the Subcommittee on Oversight concerning research and development source (R&D) allocation rules. The Subcommittee held public hearings on October 26 and November 3, 1983 for the purpose of examining Internal Code Sections 861-3, the implementing Treasury Regulation 1.861-8, and the provision contained in the Economic Recovery Tax Act of 1981 which provides for a two-year allocation rule. The Subcommittee's report includes an introduction and legislative history, and a description of the Subcommittee's recommendations and analysis of the issues.

In summary, the Subcommittee recommends that the temporary allocation rule contained in ERTA should be extended for five years. Adoption of this recommendation would provide that, during the five year period, all R&D expenses which are paid or incurred for research activities conducted in the U.S. would be allocated to U.S. income sources. In addition, the Subcommittee recommends that, in the interim, a follow-up study be conducted concerning the impact of Treasury Regulation 1.861-8 and extension of the ERTA moratorium, and that a six month study be conducted concerning the desirability and feasibility of limiting tax-free transfers of patents and other intangible property to foreign corporations.

Mr. Chairman, the Subcommittee respectfully submits its review of the issue for your consideration.

Sincerely yours,

CHARLES B. RANGEL,
Chairman.

Enclosures.

REPORT AND RECOMMENDATIONS CONCERNING RESEARCH AND DEVELOPMENT SOURCE ALLOCATION RULES

INTRODUCTION

The Subcommittee on Oversight examined the research & development (R&D) allocation issues related to Internal Revenue Code Sections 861-3, the implementing Treasury Regulation 1.861-8, and the two year allocation rule contained in the Economic Recovery Tax Act of 1981 (ERTA). The Subcommittee's review was conducted to assist the Committee on Ways and Means in addressing the issues raised by expiration of the two year moratorium contained in ERTA. The rule provided for in ERTA, in effect, suspended the sections of the Treasury Regulation relating to the allocation and apportionment of R&D expenses and allocated all R&D expense to U.S. income.

Current law prescribes rules for the allocation and apportionment of expenses to items and classes of income for purposes of determining taxable income from a source or activity. Specific rules govern the allocation of research and development (R&D) expenses incurred from activities conducted in the U.S. between U.S. and foreign source income. In many cases, an allocation of expenses between income sources is necessary in determining the amount of a taxpayer's foreign tax credit. Under U.S. law, a U.S. corporation is taxable on its worldwide income, whether earned in the U.S. or in foreign countries. Since income earned outside the U.S.,

referred to as foreign source income, is typically taxed by the country where it is earned, the U.S. allows income taxes paid to a foreign country to be credited against a taxpayer's U.S. income tax liability. However, the creditable amount is limited to an amount equal to the U.S. tax on foreign source income. The purpose of this foreign tax credit is to avoid double taxation on the foreign income of U.S. taxpayers. The purpose of the foreign tax credit limit is to prevent foreign taxes from reducing U.S. taxes on domestic source income.

To compute foreign and U.S. taxable income it is necessary to determine gross income and then to determine what deductions reduce that income. Because deductions allocated to foreign sources reduce foreign source taxable income (and thus reduce the maximum amount of foreign taxes that may be credited in any one year), it can be advantageous to taxpayers that pay high foreign taxes to minimize allocation of deductions to foreign income. In any case, the allocation of R&D expenses only affects taxpayers in an excess credit position.

To arrive at the proper definition of foreign source taxable income, taxpayers must allocate expenses related to that income. However, there is not necessarily one "correct" way to allocate expenses. Also, it is particularly difficult to allocate expenses in the case of R&D because expenses often cannot be related directly to any income. Even if R&D expenses can be related directly to the income, that income is often generated years after the research is conducted.

The allocation issue is further complicated by a number of other factors. For example, present law provides a number of incentives for R&D including immediate expensing of R&D expenditures (even though they yield no current income) and a 25-percent credit for certain incremental R&D. In addition, U.S. corporations may be able to take the fruits of R&D created in the United States and transfer them to a foreign subsidiary free of U.S. tax and without payment of a royalty to the U.S. taxpayer. As long as this foreign subsidiary does not distribute its earnings to the U.S. taxpayer, there will be no U.S. tax on the income from the fruits of the R&D. In some cases there will be no tax even when the U.S. taxpayer receives a distribution from the foreign corporation because foreign tax credits will offset the U.S. corporation's U.S. tax on that distribution. In general, only U.S. taxpayers who manufacture abroad and who use the fruits of R&D abroad, are interested in the allocation of R&D expenses.

LEGISLATIVE HISTORY

Congress has provided rules for allocation of expenses between U.S. and foreign sources since the early days of the income tax. In 1973, the Department of Treasury (Treasury) published detailed regulations setting forth rules for the allocation of R&D expenses. The R&D rules in those regulations were subject to criticism by some taxpayers on the grounds that the regulations allocated too much R&D expense to foreign income. In 1977, Treasury published another set of regulations generally requiring a substantially smaller allocation of R&D to foreign source income.

In 1981, the Congress provided a temporary allocation rule which, in effect, places a moratorium on the sections of Treasury Regulation 1.861-8 dealing with the allocation and apportionment of research and development expenditures between U.S. and foreign source income. Section 223(a) of the Economic Recovery Tax Act of 1981 (ERTA) provides that, for a two-year period, all research and experimental expenditures which are paid or incurred for research activities conducted in the U.S. shall be allocated or apportioned to income earned within the U.S. The ERTA allocation rule applies to a taxpayer's two taxable years after enactment of ERTA (August 13, 1983) and thus has expired or will expire for many taxpayers this year.

In addition, the Congress required that Treasury conduct a study with respect to the impact of the Treasury Regulation on research and development activities conducted in the U.S. and on the availability of the foreign tax credit. In June 1983, Treasury issued a report, "The Impact of the Section 861-8 Regulation on U.S. Research & Development". The Treasury Report and updated information presented in testimony before the Subcommittee indicates that:

The moratorium reduces the tax liabilities only of firms with excess foreign tax credits. Whether a firm has excess credits does not seem to be closely related to the level of its R&D efforts.

The moratorium reduced U.S. tax receipts in 1982 by approximately \$100 million and would cost \$121 million and \$133 million in 1984 and 1985, respectively.

Had the Regulation fully been in effect in 1982, the \$37 billion in privately financed domestic R&D spending in 1982 would have been reduced by approximately \$40 million to \$110 million. Most of this reduction represents a net reduction in

overall R&D undertaken by U.S. corporations rather than a transfer of R&D from a domestic to foreign location.

The moratorium has its most significant effect on large, mature multinationals, as opposed to small, relatively young high-technology companies. Of the Regulation's \$100 million to \$240 million estimated increase in U.S. tax liabilities, about 85 percent is estimated to be accounted for by 24 of the largest 100 U.S. firms.

SUBCOMMITTEE RECOMMENDATIONS

The Subcommittee on Oversight held hearings on October 26 and November 3, 1983 and received testimony from invited and public witnesses. Witnesses included Members of Congress, representatives from the Department of the Treasury, tax analysts, economists, industry associations, individual business firms, public interest groups, tax associations and other interested parties. Based upon its review and analysis of all information submitted in connection with the hearing, the Subcommittee makes the following recommendations for consideration by the full Committee on Ways and Means:

(1) The R&D source allocation rule contained in the Economic Recovery Tax Act of 1981 (ERTA) should be extended for five years (i.e. continuing the allocation of all R&D expense deductions to U.S. income sources).

(2) The Treasury should be required to: (a) Review Treasury Regulation 1.861-8 (relating to the allocation of R&D expense deductions) and take public comment on suggested revisions, (b) Undertake a follow-up study examining the impact of Treasury Regulation 1.861-8 and the effect of the suspension on R&D expenditures, employment, direct foreign investment, revenues, and the interaction of the source allocation rules with other available R&D tax incentives, and (c) Report its findings and recommendations to the tax-writing Committees, no later than June 30, 1987.

(3) Corporations claiming a foreign tax credit should supply adequate information with their returns to verify the foreign tax credit, as required under present law.

(4) The Treasury should be required to: (a) Undertake a study to determine the desirability and feasibility of limiting the non-recognition treatment of transfers by U.S. persons of patents and other intangible property to foreign corporations, and (b) Report its findings and recommendations to the tax-writing Committees, no later than April 8, 1984.

The Subcommittee examined the issues surrounding the allocation of R&D expenses from two basic perspectives. First, the Subcommittee reviewed the subject matter on tax policy grounds. The Subcommittee considered the extent to which the ERTA allocation rule and the rule set forth in Treasury Regulation 1.861-8 is consistent with the policy underlying Code Sections 861-3 and established U.S. procedures for measuring taxable income. Second, the Subcommittee was concerned about the economic impact of the Treasury Regulation and the ERTA rule. The Subcommittee received information regarding the effect of R&D allocation rules on U.S. tax liabilities and U.S. R&D activities, and the extent to which R&D allocation rules operate as an incentive to increase U.S. research and development activities and have an impact on the location of R&D jobs in the United States.

I. Tax policy considerations

The Internal Revenue Code Sections 861-3 require a taxpayer to allocate and apportion expenses (including R&D expenses) between U.S. and foreign income sources. On tax policy grounds, witnesses agreed that some allocation to foreign source income is appropriate when domestic R&D is exploited in a foreign market and generates foreign, as well as domestic, income. There are four basic tax policy reasons cited for requiring the allocation of some R&D expense to foreign source income.

First, in order to measure income more accurately, U.S. income tax laws generally attempt to match deductions with the income that the expenditures help generate. To accurately measure income in a particular year, for example, capital expenses generally are not fully deductible in the year paid or incurred, but must be deducted ratably over the period of years during which they generate income. To accurately measure income from taxable activities such as investments, a deduction is generally denied for interest paid or incurred with respect to funds borrowed to invest in securities yielding tax-exempt income. And to accurately measure foreign source income and U.S. source income, the Code (except for the temporary ERTA rule) requires allocation and apportionment of deductions between foreign and domestic gross income. Source rules for determining the taxable income of foreign persons and the foreign tax credit have been a part of the U.S. income tax laws since 1918. Without a proper computation of foreign source income, the foreign tax credit could not properly function.

While determination of the source of income that R&D deductions should offset raises difficult issues, it does not mean that some allocation between income sources should not be made. In discussing allocation of expense between income sources, witnesses emphasized that there is not a "correct" rule. Treasury Assistant Secretary for Tax Policy John E. Chapoton testified that the allocation of R&D expense, like the allocation of any expense, is required on a tax policy ground or a correct measurement of income ground. He stated that the R&D regulations are an objective attempt to address the statutory requirements of Code Sections 861-3.

The Regulation states that the method used in allocating and apportioning deductions must reflect the factual relationship between the deduction and the gross income. In addition, the Regulation sets forth detailed allocation and apportionment rules for certain types of deductions, including those for research and development (R&D) expenditures, interest expenses, stewardship expenses, and legal and accounting fees and expenses. The Regulation's R&D rules embody to some extent each of three theories for allocation and apportionment of R&D expenses, in addition to a limited tracing approach. One theory, the place-of-performance theory, assumes that these expenses reduce income from the place where the R&D occurs.

Another theory, the sales (or gross receipts) theory, assumes that R&D expenses relates to the source of the taxpayer's gross receipts. A variation of this theory, the gross income theory, assumes that R&D expense relates to the source of the taxpayer's gross income. The Regulation's "exclusive geographic apportionment" rules (referred to as the automatic and optional place-of-performances rules) are an application of the place-of-performance theory; the "sales" method is an application of the gross sales theory; and the "optional gross income" methods are an application of the gross income-to-gross income theory. The moratorium is an application of the place-of-performance theory only.

As a subsidiary issue, the hearing record reflects discussion of the appropriateness of the Treasury Regulation (1.861-8) on tax policy grounds. Gary Haufbauer, the former Treasury official responsible for drafting the Treasury Regulation 1.861-8, provided a detailed legislative history of the Regulation. He stated that when Treasury issued the Regulation in final form in 1977, he thought "we would be pilloried for engineering a massive giveaway to the multinationals." Memoranda he attached to his testimony describe Treasury's final Regulation as an attempt to establish rules which would allocate as much R&D expense to U.S. sources as possible. Treasury Assistant Secretary for Tax Policy John E. Chapoton noted that Treasury has heard very little complaint about the technical aspects of the Regulation or that the Regulations require too much allocation of R&D expenses abroad.

Finally, Professor Lawrence Lokken commented that the Regulation requires less allocation to foreign source income than the general source allocation rules might imply. He noted that a firm required to allocate 50 percent of R&D expenses (based on sales) under the 1973 proposed Regulation would only be required to allocate 17½ percent under the 1977 final Regulation. In contrast, Professor Jon Bischel testified that the thrust of the regulations is to "arbitrarily" allocate current R&D expenditures and that such allocation and apportionment is made "without any causal relationship". Further he stated his opinion that the definitions and classifications under the Regulation by product line do not make sense. Holding a similar view, various industry witnesses emphasized that the Treasury Regulation is complex, hard to understand, and requires complicated calculations.

Second, an allocation of expenses between income sources insures that the effect of the foreign tax credit limit is preserved. U.S. persons are taxable on their worldwide income, including their foreign income. In other words, the taxable income reported on the U.S. tax return of a U.S. person includes both U.S. and foreign income. Since a U.S. person who earns foreign income may incur foreign income tax, the United States has allowed U.S. persons to take a full, dollar-for-dollar credit for foreign income taxes. A foreign tax credit has been available since 1918 and directly reduces U.S. tax. In 1921, however, the foreign tax credit amount was limited to allow the credit to reduce U.S. tax on foreign income, but not U.S. tax on U.S. income. Without this limitation, the foreign tax credit would permit foreign countries to preempt the U.S. tax base.

The foreign tax credit is limited to the U.S. tax on the foreign income. A simple way of expressing the foreign tax credit limitation is "the U.S. tax rate (perhaps 46 percent) times foreign taxable income." In other words, a firm can take a foreign tax credit for either foreign income taxes paid or 46 percent times foreign taxable income, whichever is less. A fundamental premise of the foreign tax credit is that foreign taxes should not offset the U.S. tax on U.S. source income. Accordingly, a statutory formula limits the foreign tax credit so that the credit will offset only the U.S. tax on the taxpayer's foreign income. The source allocation rules should not

allow a U.S. company with domestic and overseas operations to pay less U.S. tax on U.S. income than a U.S. company operating only in the U.S. (who only has U.S. income).

Failure to allocate expenses between U.S. and foreign income sources has the effect of increasing the foreign tax credit limit. For taxpayers in (or near) an excess credit position, this will have the effect of reducing U.S. tax on U.S. source income. With an unlimited credit, foreign countries could effectively levy a tax on U.S. source income by raising their tax rates above 46 percent. Second, absent a limitation, the U.S. Treasury would bear the burden of this foreign tax (to which taxpayers could be indifferent). In other words, the Treasury would lose U.S. tax revenue on U.S. source income. The foreign tax credit limitation thus tends both (1) to prevent other countries from taxing the U.S. tax base, and (2) to protect the Treasury's right to tax U.S. source income. Increasing the credit limit by suspending the R&D Regulation effectively allows foreign government to levy a tax on U.S. source income. The impact is borne by the U.S. Treasury. The Treasury Department estimates that in calendar year 1982 the ERTA allocation rule cost \$100 million. A two year extension of the ERTA rule would cost approximately \$121 million in 1984 and \$133 million in 1985.

Third, the ERTA moratorium allows, in some instances, a double deduction of R&D expenses. The double deduction case arises under the moratorium when the parent company deducts 100 percent of domestic R&D expense against U.S. source income, and its foreign affiliate, in accordance with a tax treaty, deducts (against foreign tax) a royalty payment for exploitation of this R&D. Consequently, the moratorium allows excess credit companies to receive a double deduction for a portion of U.S. performed R&D expense.

Fourth, the ERTA rule may remove the incentive of many companies to press for a change in foreign countries taxing practices which discriminate against U.S. firms. Issues were raised regarding whether tax Code provisions, such as the source allocation rules, should be used to protect firms locating in high effective tax rate foreign countries from discriminatory foreign tax practices. Witnesses noted that the question becomes whether the U.S. should "undertax" the domestic source income of U.S. firms because foreign countries "overtax" the firms' foreign income. Treasury Assistant Secretary for Tax Policy John E. Chapoton agreed that, if the ERTA rule is made permanent, the law would remove the incentive of many companies to press for less discriminatory taxation.

II. Economic considerations

In terms of the source allocation rules providing an incentive for increased U.S. research and development, the analysis is an economic one and fundamentally different from the discussion of the source rules on a tax policy basis. As stated by Treasury Assistant Secretary for Tax Policy John E. Chapoton, "it should be clear that the ERTA suspension or any rule of law requiring no allocation of R&D expense to foreign source income to which expense relates should not be viewed as an attempt to correctly measure the source of income, but as a tax incentive to encourage domestic R&D activity." The overwhelming justification cited for allocating all R&D expense to U.S. sources was that, on balance, the economic considerations related to source allocation rules are more important than the tax policy considerations. As presented by Congressman James Shannon who testified before the Subcommittee, "the importance of maintaining and improving our domestic R&D capacity, and jobs associated with it, far outweigh any other consideration". Similarly, Congressman Cecil Heftel testified that "As a general rule, there are legitimate tax policy reasons for allocating expenditures to the income that they generate . . . indeed, in the case of R&D expenditure allocation, our experience bears out that such allocation is not only inordinately complex but directly contradicts other important policy goals".

Numerous other witnesses appeared before the Subcommittee testifying the source allocation rule provided in ERTA serves as an important tax incentive for R&D. In summary, industry witnesses testified in support of a rule which would permanently allocate all R&D expense deductions to U.S. income sources. Further, they stated that such a rule would expand deductions significantly increase domestic R&D and would mean the retention of R&D jobs in the U.S. Several major points were discussed in connection with the industry's position.

The Subcommittee also received testimony concerning the interaction of R&D source allocation rules with the practice of foreign countries in disallowing certain business deductions. Many witnesses argued that it is unfair for the U.S. to allocate R&D deductions to foreign sources when the foreign country does not allow a deduction for the allocated amount for purposes of calculating foreign income taxes. The

Electronics Industries Association (EIA) explained why such a situation creates a disincentive to research and development. "Under the section 861 regulations, the allocation of expense rules act as a disincentive to research and development because of the economic cost it imposes on the performance of domestic R&D. The effect of these rules is to deny U.S. corporations a full deduction against U.S. income for purely domestic R&D expenses. Such expenses, when allocated to foreign sales, are not permitted as a deduction against taxable income by foreign tax authorities either, because no direct benefit accrues to the foreign entity. Nor are they viewed as deductible costs of doing business in the foreign country. The result is a loss of tax benefit for a portion of R&D expenses, and exposure for a portion of income to both U.S. and foreign taxation. This occurs because the allocation of R&D expenses to foreign source income has the effect of reducing the amount of foreign tax credit allowed currently and of increasing the corporation's overall tax liability."

The Foxboro Company discussed the effect of the Regulation, using its own experience as an example. "First, the increased cost provides a disincentive for U.S. companies to invest in R&D in the U.S. In 1979 and 1980, for example, my company had excess foreign tax credits which it could not use in its tax returns as originally filed. We would not have had those unused credits if R&D spending had remained at 1978 levels. In fact, the operation of Regulation 1.861-8 was such that in 1979 and 1980 the increase in R&D expenses allocated to foreign source income grew even faster than the underlying rate of growth of our overall R&D budget. This increased apportionment to foreign source income further reduced our usable foreign tax credit and thereby increased the cost of undertaking increased R&D in the U.S. . . . A second consequence is that it provides an incentive for U.S. taxpayers to perform R&D outside of the U.S.

Once again, my own company provides a case in point. For many years, Foxboro tended to centralize all of its R&D efforts in the U.S. However, in 1980 a decision was made to establish a European R&D operation. The Foxboro Company now has R&D activities underway in its subsidiaries in both the Netherlands and the United Kingdom as well as in the U.S. Our reasons for relocating these activities were a combination of shortages of key technical skills in the U.S., U.S. tax penalties, and other factors. We already had a support infrastructure in place in Europe and have found no difficulties in directing and coordinating this activity from the U.S. . . . Thus, the decision to expand R&D operations abroad rather than in the U.S. was from a business point of view entirely feasible and from a tax point of view clearly advantageous. . . . As an aside, I would like to note that, as I mentioned above, shortages of key technical personnel were a major factor in our decision to relocate abroad."

In agreement with the industry's view, Treasury stated that U.S. corporations can rightfully claim that they are disadvantaged by the refusal of foreign governments to recognize R&D performed outside the country even though related to income produced and taxed in the country. However, the Treasury also noted that the result would be the same even if the foreign government permitted a deduction for foreign R&D, but imposed a tax rate far above the U.S. level. In either case, granting a U.S. taxpayer foreign tax credits above those permitted by the tax credit limitation would allow foreign taxes to offset U.S. tax liabilities on domestic income.

Gary Haufbauer of the Institute for International Economics similarly pointed out that some countries disallow a deduction for royalty payments made to foreigners; many countries strictly control royalty payments made by a domestic corporation to a foreign sister or parent corporation; and many countries impose high withholding taxes (15 percent and more) on royalty payments made to foreigners. He noted that in the absence of a Section 861 allocation, these various restrictive practices would serve to deny the U.S. Treasury much chance of recouping any tax revenue from income earned on the exploitation abroad of research conducted in the U.S. In more detail, tax expert Charles Kingson testified that firms only have an incentive to go abroad to the extent deductions allocated under the Regulation exceed the amount of royalties that the foreign subsidiary is allowed to pay the U.S. parent. If the amount of deductible royalties equals the amount of research that the Regulation allocates to those royalties then, unless there is a foreign withholding tax on the royalties, the company has no incentive for relocating the facilities abroad no matter how much of an excess credit position it is in.

In a background pamphlet prepared at the request of the Subcommittee (JCS-49-83), the staff of the Joint Committee on Taxation notes that U.S. income tax treaties generally require our treaty partners to allow appropriate deductions for expenses incurred in the U.S. Generally, however, under the treaties, these countries are required to allow deductions only for R&D expenses directly related to local income.

Some R&D conducted in the U.S. within a product category that includes products sold in a foreign country may not bear a direct relation to local income. A foreign country's disallowance of deductions for such R&D when those amounts are allocated to foreign income under the R&D Regulation may, therefore, comport with its treaty obligations.

Even absent a treaty, a deduction for overseas R&D is within the scope of many countries' general rules governing deductions for overseas expenditures. Denmark, Ireland, the United Kingdom, and South Africa, for example, apparently do not generally distinguish in their internal law between domestic and foreign based R&D expenses for purposes of the deduction each permits for R&D expenses. However, foreign countries that recognize the right of taxpayers to deduct overseas expenses may not allow deductions in sufficient amounts to offset the impact of the R&D Regulation. Even if foreign countries allow deductions for R&D performed in the U.S., they may impose gross withholding taxes on royalty payments to U.S. companies for that R&D. Such withholding taxes reduce the benefit of foreign deductions for U.S. R&D. While some foreign countries may prohibit direct deductions for U.S. performed R&D, a U.S. company may be able to obtain a deduction indirectly in some cases by increasing the price of technology and components sold by the corporate parent to its foreign subsidiary to reflect R&D costs. Transfer prices paid by foreign subsidiaries for technology and components often are deductible under foreign tax laws.

Two other important and related issues the Subcommittee received testimony on were the relationship of R&D source allocation rules to the location of R&D jobs in the U.S. and to increased domestic R&D under the various allocation approaches. While the Subcommittee received a substantial amount of information and materials which address these issues, important unanswered questions remain. A summary of the information presented to the Subcommittee follow:

According to the Treasury Department's June 1983 study, the impact of the R&D Regulation is unclear. Based on National Science Foundation data, the Treasury study shows that, following the promulgation of the Regulation in 1977, the foreign share of R&D expenses by U.S. companies and their foreign affiliates dropped from 9.08 percent in 1978 to 8.20 percent in 1981. Thus, the aggregate statistics do not show a shift of R&D offshore after the Regulation was adopted; however, the Treasury study notes that the foreign share of R&D does not depend solely on taxes.

The Treasury study also reviewed several economic analyses of the overseas R&D activity of multinational companies. This survey indicated that multinationals locate R&D offshore primarily to transfer developed technology or to adapt technology to indigenous factors of foreign markets, rather than to develop new technologies or new products for a worldwide market. Treasury's literature survey also indicated that there are important efficiency advantages of centralized R&D which make the establishment of offshore R&D units unattractive to multinational companies. The Treasury study concludes that, "Based on these considerations, it appears that foreign R&D is not highly substitutable for R&D performed in the U.S."

The primary importance of factors other than taxes in the R&D location decision is confirmed in a study by Arthur Andersen and Company. Based on a survey and responses of 85 major multinational firms, the Arthur Andersen study found that, "the most common incentive for determining timing, placement, and scope of R&D projects is the competency of the available work force . . . geographical location of necessary raw materials and research data [is] the second most frequent response. While the Arthur Andersen study found that taxes have some influence on the location of R&D investment, this factor was not of primary importance to the firms included in the survey.

Based on the Treasury study, and the other economic analyses cited therein, it would appear that there is little evidence that the 1977 Regulation resulted in a large shift of R&D offshore, or that such a shift would occur if the Regulation's R&D rules were reimplemented. Also, it should be noted that shifting R&D activity offshore is not the only tax planning strategy available for reducing excess credits. An alternative option is to shift manufacturing activity from a high tax foreign country to a low tax country. (Ireland is a popular low tax country for firms manufacturing for the European market). However, there may be situations where a U.S. company can most easily reduce excess credits by locating R&D offshore, and under these circumstances tax considerations may influence the location of R&D activities.

As discussed by industry witnesses, particularly the Deere Company and the Foxboro Company, suspending the Regulation will reduce the tax costs of operating in high tax foreign jurisdictions for some taxpayers, thereby increasing the relative attractiveness of operating abroad. Suspending the Regulation reduces tax costs because the Regulation reduces foreign source income and, therefore, under the for-

eign tax credit limitation, the amount of foreign taxes that can be credited to reduce U.S. tax. This makes it easier for some taxpayers to use foreign tax credits to reduce U.S. taxes.

The Treasury study examined the issue of whether the Treasury Regulation served as a disincentive to increased U.S. R&D. Treasury found that as a result of suspending the Regulation's R&D rules, privately financed U.S. R&D was increased in 1982 by 27 to 65 percent or about \$40 million to \$260 million. Treasury's most recent estimate of the revenue cost of the moratorium in 1982 is \$110 million. Thus, the increase in domestic R&D per dollar of revenue loss is estimated to be approximately \$.40 to \$2.30.

The Treasury study also points out that the tax benefits of suspending the Regulation will be highly concentrated: 24 firms are estimated to obtain 85 percent of the tax benefit. In addition, the benefit will go only to firms with excess foreign tax credits and these may not be the same firms with the most promising research opportunities. The Treasury study concludes that "all firms are not affected uniformly by the suspension of the Regulation. It only reduces the tax liabilities of firms in an excess foreign tax credit position. These firms earn from 16 percent to 22 percent of the worldwide income of U.S. manufacturing corporations. Whether or not a firm is in an excess credit position does not seem to be closely related to the level of its R&D effort. The suspension of the Regulation has its most significant impact on large, mature multinational firms, as opposed to small, emerging, high technology companies." Thus, the Treasury study implies that there may be more effective, less haphazard methods to increase domestic R&D, at a lower revenue cost, than the suspension of the R&D rules of the Regulation.

III. Conclusion

The Department of Treasury's analysis considered both the tax policy issues and the R&D tax incentive issues raised at the hearing. In doing so, Treasury concluded that the present moratorium should be extended to permit taxpayers to allocate all U.S.-based R&D expenses to U.S. source income for two additional taxable years. The Treasury report states that this "will give the Congress an opportunity to consider the findings of this report while the Congress and the Administration work to develop a coherent national program of R&D incentives".

The Subcommittee on Oversight generally supports the Treasury position and recommends that the Congress extend the temporary rule contained in ERTA for five years. The Subcommittee's recommendation is based on the view that there is a significant tax policy justification for continuing the present law requirement that R&D expenses be allocated between U.S. and foreign source income. Further, changes to established tax allocation principles should not be made unless some competing factor overwhelmingly justifies a statutory change.

In recommending a five year extension, the Subcommittee recognizes that the source allocation rules are important to many firms claiming the foreign tax credit and that for firms in (or near) an excess credit position the tax effect of source allocation rules can be substantial. Further, the Subcommittee agrees that, for certain firms, the Treasury Regulation may serve as an incentive to locate R&D operations overseas. However, it must be noted that the benefits generated from the ERTA rule are only received by a limited number of firms in an excess credit position, and that a significant portion of the benefit goes to several large multinational firms. Also the Subcommittee was unable to determine, from information submitted at the hearing, the economic impact of the Treasury Regulation or the ERTA rule with sufficient specificity. Much needed information is not currently available. For example, additional information is needed to evaluate the extent to which R&D jobs will be shifted overseas under the Treasury Regulation. In balancing the tax policy issues involved against the limited amount of information available indicating that the ERTA rule serves as an incentive for increased U.S. R&D activities, the Subcommittee therefore urges an extension of the ERTA moratorium.

The Subcommittee also makes two recommendations to expand the information available to the Congress, Treasury, and the Internal Revenue Service in evaluating R&D source allocation issues. Additional information concerning impact of the ERTA rule will assist all interested parties in better evaluating the impact of the ERTA rule and whether changes should be made to the Treasury Regulation. The first recommendation would require Treasury to solicit and take public comment on issues relating to Treasury Regulation 1.861-8. At the same time, the Subcommittee recommends that Treasury conduct a follow-up study to evaluate the impact of the Treasury Regulation and the ERTA moratorium on R&D expenditures, employment, revenues, foreign investment, and the interaction of the source allocation rules with other available R&D tax incentives. This report should be filed with the tax-writing committees no later than June 30, 1987.

Second, the Subcommittee recommends that the Treasury take appropriate steps to insure that corporations claiming the foreign tax credit supply adequate information with their returns to verify the credit, as required under present law. It appears that a significant number of taxpayers claiming the foreign tax credit do not supply information concerning how the deductible amounts have been allocated or which portions of deductible amounts are attributable to R&D expenses, even though Form 1118 requires taxpayers to attach schedules with such information. This information would be useful in auditing compliance with the allocation rules and also would assist the Treasury and the Congress in evaluating the appropriateness of present law.

In testimony before the Subcommittee, Treasury explained that corporations claiming a foreign tax credit are required to report on form 1118, Computation of Foreign Tax Credit, the "Ratable Part of Deductions Not Definitely Allocable" to foreign source income. The total amount of expenses apportioned to foreign source income is supposed to be reported on the Form and a supporting schedule showing a detailed calculation by type of expense is supposed to be attached. Unfortunately, many corporations do not provide the required supporting information with their returns even though the form requires that the information be supplied as an attached schedule.

Large corporations which are audited every year tend to provide a bare minimum of information on their returns and note that the detail will be available upon audit. For example, they may report a total figure for taxable income from foreign sources without indicating specific deductions. As a consequence, in preparing the foreign tax credit supplement to the 1980 Corporation Statistics of Income file, IRS found that more than \$3 billion of deductions allocated to foreign source income under the section 861 were not documented. This represented virtually all of the "Deductions Not Definitely Allocable" and about 20 percent of all deductions attributable to foreign source income. In addition to failing to report totals for many items, it appears that less than half of the dollar amount of income, deduction, and tax items reported by corporations is supported by country detail.

The final recommendation of the Subcommittee would require Treasury to conduct a study and prepare a report concerning the tax-free transfer of patents and other similar intangibles to overseas manufacturing subsidiaries. Witnesses, including Congressman Donald Pease, Robert McIntyre from the Citizens for Tax Justice, and Robert McGarrah from the American Federation of State, County, and Municipal Employees Union discussed this issue at the hearing. They urged the Subcommittee to adopt a proposal to insure that once the Subcommittee takes steps to encourage the location of R&D operations in the U.S. through extending the ERTA rule, that steps also be taken to insure that the law does not provide an incentive to ship the fruits of the U.S. R&D overseas.

Briefly, the witnesses questioned the policy of providing tax incentives to encourage multinationals to do U.S. R&D when they may use the results of that R&D abroad tax-free. R&D produces intangible assets, including patents, know-how, and secret processes. U.S. companies may transfer the intangibles that their R&D produces to foreign subsidiaries without incurring U.S. tax under Internal Revenue Code Section 367. The foreign subsidiaries may generally use those intangibles, created in the U.S., in active manufacturing for foreign markets without incurring U.S. tax. The principle of deferral generally prevents imposition of U.S. tax on the income of those foreign subsidiaries until they pay dividends to their U.S. parent corporations.

If a foreign subsidiary of a U.S. corporation manufactures in a country whose effective tax rate is lower than the U.S. rate, it will have a tax competitive advantage over U.S. companies that operate solely in the U.S. A U.S. corporation with valuable intangible assets arising out of U.S. R&D may have a tax incentive to locate its manufacturing plants in low-tax foreign countries rather than in the U.S. This will depend on whether the investment credit, accelerated depreciation, and other tax preferences provided to U.S. manufacturers are as valuable as deferral. In some cases, the tax advantage from establishing a new manufacturing plant outside the U.S. in a low-tax country may outweigh the economies of scale that arise from expanding an existing U.S. manufacturing plant. In addition, if the foreign subsidiary of a U.S. corporation received valuable intangible assets (the fruits of U.S. R&D) without paying for them, it has a competitive advantage over companies that operate solely in that foreign country. Those wholly local companies must pay for their intangible assets, either by incurring R&D expenses or by paying for intangible assets.

The Subcommittee believes that additional information about such tax-free transfers is needed. As a result, the Subcommittee recommends that the Treasury prepare a study on the desirability and feasibility of limiting the non-recognition of

transfers of U.S. persons of patents and other intangible property to foreign corporations. So that this report addresses the Committee's main concerns, the Treasury report should include: (a) a description of Internal Revenue Code Section 367, (b) a description of the use of the tax-free transfer provisions, (c) a discussion of the tax policy and economic issues involved, (d) an analysis of the extent to which the rules benefit firms manufacturing overseas and encourage the shift of intangibles overseas, (e) an estimate of the revenue effects of continuing present law rules, (f) an explanation of the Internal Revenue Service's tax-free transfer approval procedures, (g) an analysis of the alternative legislative approaches for limiting tax-free transfers, and (h) the Treasury's findings and related recommendations to the Congress. This study should be submitted to the tax-writing Committees, no later than April 30, 1984.

